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Reporting foreign operations of U. S. companies in U. S. dollars; Accounting research study no. 12

Leonard Lorensen

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AN ACCOUNTING RESEARCH STUDY

REPORTING FOREIGN OPERATIONS OF U. S. COMPANIES IN U. S. DOLLARS

By Leonard Lorensen, CPA

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Individuals and groups are invited to express their views with supporting reasons on the matters in this study. The Director of Accounting Research will send comments received to the Financial Accounting Standards Board as well as to the present Accounting Principles Board. Comments will be treated as public information unless a writer requests that his comments be confidential.

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ACCOUNTING
RESEARCH
STUDY NO. 12

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By Leonard Lorensen, CPA

Project Manager

American Institute of Certified Public Accountants

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Director's Statement

Recent events involving the international monetary system highlight the impact on financial reporting of changes in foreign exchange rates and again remind accountants that existing procedures for translating amounts stated in foreign money into U.S. dollars were developed long ago under other circumstances. Accountants and businessmen have responded to those events with a number of *ad hoc* proposals to change accounting. Unfortunately, those *ad hoc* methods proposed are more distinguished for producing results that their advocates judge to be desirable or "more realistic" than for either thorough analysis or consistency with existing basic notions of accounting. My observations on trying to improve accounting through *ad hoc* methods and on some *ad hoc* proposals related to this accounting research study follow the comments of a member of the project advisory committee.

Samuel R. Hepworth, late professor of accounting at The University of Michigan, began the project. Professor Hepworth was a pioneer in recommending changes in the outmoded translation procedures that were developed before the Second World War. He was among the first to see parallels between translation and restatement of financial statements for changes in the general price level and the first to develop translation procedures using those parallels. He developed a translation method based on distinguishing between monetary and nonmonetary assets and liabilities about twenty years ago and published his work in 1956.

Professor Hepworth had finished a first draft of this accounting research study at the time of his death in 1967. The monetary-nonmonetary distinction contained conceptual weaknesses for translation, but Professor Hepworth had laid a solid foundation for future progress.

Leonard Lorensen, who did not work on the study during Professor Hepworth's lifetime, completed it. He saw theoretical gaps in the monetary-nonmonetary method, and those insights led to the temporal principle. The temporal principle is not just a new name for the

monetary-nonmonetary method, as some may think, but stems from key conclusions about the nature of accounting and the translation process. No one can say, of course, whether Professor Hepworth would have accepted the temporal principle that was built on his foundation.

I wish to thank members of the project advisory committee for valuable assistance in reviewing several drafts of the study and in giving suggestions and criticisms. Present committee members are Roy Blough, Joseph P. Cummings, John J. Deering, Alan W. Drew, Arthur B. Foye, George C. Watt, and C. A. Moyer, Chairman; C. E. Graese served on the committee in the beginning stages of the study. All present members of the committee favored publication of the study, and one member contributed comments which are published following the study (pages 96 to 101). The fact that a committee member approves publication, omits comments, or restricts comments to specific parts or aspects should not be interpreted as concurrence with the contents, conclusions, or recommendations of the study.

Although procedures for issuing pronouncements on accounting principles or standards are in transition, I invite interested individuals and groups to read the study carefully and submit comments on it. Comments submitted will be most useful if they cover not only the conclusions but also the analysis, premises, and arguments and if they include supporting reasons. I will send the study and all comments received to the Financial Accounting Standards Board when it begins operation.

New York, N. Y., June 1972

REED K. STOREY
Director of Accounting Research

Author's Preface

U.S. dollar foreign exchange rates for the moneys of many countries rose significantly during the crisis in the international monetary system that occurred in 1971. The rate rises were unusual because U.S. dollar foreign exchange rates have generally fallen since World War II. A misconception that accompanied the crisis was that rises in foreign exchange rates require different translation principles than falls in rates. I have tried to dispel that misconception in this study. A translation principle should be suitable for all kinds of rate changes, and the principle developed in the study fulfills that requirement.

A foreign subsidiary that has long-term debt in foreign money outstanding when the U.S. dollar foreign exchange rate for the money changes recognizes a dollar gain or loss on the debt under the temporal principle proposed in the study. The foreign subsidiary also has a more or less offsetting dollar loss or gain on the change in the *current value* in terms of dollars, however defined, of the plant and equipment. As some accountants put it, the change in rate results in no "economic" or "overall" gain or loss to the extent that the gains or losses on the two items offset. Accountants that want to recognize in the translated financial statements that no economic or overall gain or loss has occurred are in a dilemma because no acceptable way presently exists to do so.

Some of those accountants want to resolve their dilemma by (1) suppressing recognition of the gain or loss on the long-term debt through deferring it or (2) translating the historical cost of plant and equipment at the current foreign exchange rate, but neither of those courses of action is acceptable for reasons discussed in the study. Others want to resolve their dilemma by stating plant and equipment at current value in the foreign money financial statements and translating that amount at the current rate. That course of action is also unacceptable, however, because it results in stating plant and equip-

ment of foreign subsidiaries in consolidated statements on a basis different from that used for the domestic companies.

The dilemma is thus unresolvable as long as the historical-cost basis of accounting continues to be used.

I want to thank the many people who have helped me in the course of the study. Members of the project advisory committee for the study and members of the Accounting Research Division of the AICPA, as well as numerous other persons, provided constructive criticism at every stage. Paul Rosenfield and Thomas W. McRae of the Accounting Research Division provided important conceptual contributions.

New York, N. Y., June 1972 LEONARD LORENSEN

1

Introduction

The Problem

Operations of U.S. companies in foreign countries have increased significantly over the past two decades. United States direct foreign investment—the cumulative investment of U.S. companies and private investors in foreign branches and controlled affiliates—rose from $11.8 billion in 1950 to $78.1 billion in 1970.[1] The percentage of major U.S. industrial corporations that operate in foreign countries has increased since the end of World War II. Of the 600 companies included in the American Institute of Certified Public Accountants (AICPA) annual survey of major U.S. industrial corporations for 1971, 74% reported investments in foreign operations as contrasted with only 35% of the 525 corporations included in the survey for the year ended June 1947, which was the year of the initial survey.[2] Increases in U.S. direct foreign investment and in the percentage of major U.S. industrial corporations that operate in foreign countries have been accompanied by an increase in earnings from U.S. direct foreign investment from $3.0 billion in 1958 (when direct foreign investment was $27.1 billion) to $10.8 billion in 1970.[3]

Today, an American investor is likely to invest indirectly in foreign operations whenever he buys the stock of a U.S. company. He may find that the foreign operations of a single U.S. company are comprised of

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[1] United States Department of Commerce, *Survey of Current Business*, October 1969, p. 24 and October 1971, p. 26.

[2] *Accounting Trends & Techniques*, Twenty-fifth Edition, 1971, p. 204; *Accounting Survey of 525 Corporate Reports*, 1948, p. 4.

[3] United States Department of Commerce, *Survey of Current Business*, August 1959, pp. 25-32 and October 1971, p. 26.

the diverse operations of affiliated companies located in many countries around the world.

Need to Translate. A U.S. company with substantial foreign operations must prepare financial statements in U.S. dollars for foreign subsidiaries[4] before it can present general-purpose financial statements. Financial statements in U.S. dollars of foreign subsidiaries are needed to prepare combined or consolidated financial statements that include the subsidiaries, to compute the parent company's equity in net assets and earnings of foreign subsidiaries accounted for by the equity method,[5] and to provide supplementary information for investments in foreign subsidiaries accounted for at cost.[6]

Financial statements in U.S. dollars could be prepared for foreign subsidiaries from the subsidiaries' accounting records if the records were kept in terms of U.S. dollars. Accounting records of foreign subsidiaries are generally kept in terms of foreign money, however, because business in foreign countries is generally transacted with foreign money as the medium of exchange. Financial statements prepared from those accounting records are stated in terms of foreign money. To pre-
2 pare U.S. dollar statements, amounts in financial statements of foreign subsidiaries must therefore be changed from amounts stated in foreign money to amounts stated in U.S. dollars. The process of changing the amounts from foreign money to U.S. dollars is commonly called "translation."

Means of Translation—Foreign Exchange Rates. Since the money of one country is usually not accepted to a significant extent as a medium of exchange in another country, transactions between parties in different countries require arrangements for the exchange of the moneys of the different countries. Foreign exchange markets—institutional arrangements for the exchange of moneys of different countries—exist in most countries to facilitate international transactions. Foreign exchange rates, which are the prices at which moneys are exchanged in foreign exchange markets, provide the means to translate

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[4] For convenience, the term "foreign subsidiaries" includes foreign branches in this study.

[5] AICPA, *Accounting Principles Board Opinion No. 18*, "The Equity Method of Accounting for Investments in Common Stock," March 1971, par. 14.

[6] AICPA, *Accounting Research Bulletin No. 51*, "Consolidated Financial Statements," 1959, par. 21.

financial statements of foreign subsidiaries stated in foreign money into financial statements stated in U.S. dollars. A financial statement amount in foreign money is translated into U.S. dollars by multiplying it by a foreign exchange rate expressed in U.S. dollars.[7]

Variety of Foreign Exchange Rates. Translation would involve few if any problems if the exchange rate between moneys were immutable and unambiguous like the conversion factor between a meter and a foot. However, exchange rates in foreign exchange markets vary over time in response to complex supply and demand factors whose effects may be controlled but not completely eliminated by governmental participation in the market. Furthermore, different rates prevail concurrently for different types of foreign exchange transactions. Both kinds of variations in foreign exchange rates are discussed in this study to determine bases of selecting foreign exchange rates for translation.

The IMF System of Exchange Rate Stabilization. The International Monetary Fund (IMF) was organized in 1944 by the non-Communist countries to establish a flexible system of exchange rate stabilization. Under that system, the United States establishes an official exchange rate for the dollar in terms of gold; other member countries establish two official exchange rates for their moneys, one expressed in terms of gold and the other expressed in terms of dollars. The member countries that establish an official dollar rate for their moneys agree to keep the actual dollar rate within 2¼ % (1% before December 1971) of the official dollar rate. Most countries, including the major industrial countries, allow their moneys to trade freely in the foreign exchange market. However, a country keeps the actual rate of exchange within 2¼ % (1% before December 1971) of the official rate by buying its money with U.S. dollars or gold or selling its money for U.S. dollars or gold in the foreign exchange market whenever free market forces threaten to drive the rate below or above the limits. The IMF assists members in stabilization activities by making gold or U.S. dollars available to them when needed. A few member countries that do not allow their moneys to trade freely keep the actual dollar rate for their moneys at the official level by fiat.

A persistent imbalance in the supply of and demand for the money of a country in the foreign exchange market often makes the official

[7] Proposals to translate by factors other than foreign exchange rates are discussed in Chapter 4.

dollar rate unrealistic as a support level, and the government becomes unwilling or unable to continue supporting that rate. The government then consults with the IMF and establishes a new official dollar rate. For example, the official rate for the British pound was $2.80 for many years, and the British government kept the actual rate within the range of $2.78 to $2.82. In 1967 the British government was no longer able to maintain the actual rate at that level and after consulting with the IMF reduced the official rate for the pound to $2.40. The actual rate was kept within the range $2.38 to $2.42 from 1967 to 1971.

Exchange rates therefore change over time in two ways under the system established by the IMF. First, the rate fluctuates within a narrow margin agreed on by the government concerned and the IMF. Second, the rate is allowed to rise or fall to a new support level after the government consults with the IMF. A rate change within the narrow margin is called a *fluctuation;* a rate change to a new support level is called a *devaluation* if the dollar rate falls, and a *revaluation* if the dollar rate rises.

Some members of the IMF allow their moneys to trade freely and do not stabilize the exchange rates for their moneys at an established level.[8] The terms fluctuation, devaluation, and revaluation do not apply to changes in the exchange rates for these moneys, and no particular terms are used to distinguish between normal and abnormal changes in rate.

The IMF system was seriously undermined in recent years by a large and sustained net outflow of dollars from the United States to other countries. Although many countries experienced dollar shortages, Japan and certain European countries experienced large dollar surpluses. The United States government urged "dollar-surplus" countries to revalue their moneys to stem the outflow but had little success because countries enjoy a trade advantage by keeping the dollar rate for their moneys as low as possible. Dollar-surplus countries were willing to accumulate large quantities of dollars to keep the dollar rate for their moneys down because the United States was committed under IMF rules to redeem the dollars accumulated on demand for gold at $35 an ounce. The United States suspended that commitment in August 1971

[8] As of December 31, 1970, the exchange rates of the moneys of Afghanistan, Bolivia, Canada, Chile, Colombia, Costa Rica, Indonesia, Lebanon, and Peru were free to seek their own level. Source: *International Financial Statistics,* March 1971, prepared by the Statistics Bureau of the International Monetary Fund.

and consequently provoked the dollar-surplus countries into allowing the dollar rate for their moneys to rise.

The rises in dollar rates of the dollar-surplus countries occurred over a period of several months. However, the governments of the dollar-surplus countries controlled the rates at all times by participation in the foreign exchange market. Countries without dollar surpluses continued to keep the dollar rates for their moneys at the official rate level, and a few dollar-short countries devalued their moneys. The description that was often made during this period of the U.S. dollar as "floating" was thus inaccurate if a "floating" dollar means a dollar whose price in terms of other moneys is free to fluctuate.[9]

The rises in dollar rates impeded trade between the United States and the dollar-surplus countries because the rises did not occur as the result of an international agreement to establish new official rate levels. This impediment was removed when new official rate levels were established in December 1971 by agreement between the United States and the dollar-surplus countries. Under the agreement dollar rates are permitted to rise and fall 2¼ % above and below the new official rates instead of 1% as previously permitted. The President of the United States promised as part of the agreement to ask Congress to raise the price of gold from $35 to $38 an ounce after a new trade agreement is reached with the dollar-surplus countries.[10] Suspension of the commitment to exchange gold for dollars will apparently continue.

The crisis that occurred in the IMF system in 1971 indicates that controlling exchange rates through international agreement is difficult. Whether control will continue in the future over a long period of time is uncertain. What is certain, however, is that foreign exchange rates will continue to change over time in response to supply and demand forces. That is the significant feature of foreign exchange rates in translating financial statements stated in foreign money into U.S. dollars.

Translation in Current Accounting Practice

Two alternative methods of translation are used by U.S. companies in current accounting practice. One is based on the distinction between

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[9] "The exchange rate structure thus emerging after August 15 was, in most instances, the product of controlled rather than free floating." Federal Reserve System, *Federal Reserve Bulletin*, October 1971, p. 786.

[10] A law raising the price of gold from $35 to $38 an ounce was passed by Congress and signed by President Nixon on April 3, 1972.

current and noncurrent assets and liabilities; the other is based on the distinction between monetary and nonmonetary assets and liabilities. Under the current-noncurrent method, assets and liabilities classified as current are translated at the foreign exchange rate in effect at the balance sheet date, and assets and liabilities classified as noncurrent are translated at the rates in effect at the dates on which they were acquired or were otherwise recorded in the accounting records of the foreign subsidiary. Under the monetary-nonmonetary method, assets and liabilities that are monetary are translated at the foreign exchange rate in effect at the balance sheet date, and assets and liabilities that are nonmonetary are translated at the rates in effect at the dates they were acquired or otherwise recorded in the accounting records of the foreign subsidiary.

The current-noncurrent method is the traditional one and was first described and recommended by the AICPA in a report issued in 1931 by a special committee on accounting procedure,[11] and was also recommended in another report by the committee issued in 1934.[12] The special committee dealt with the problem of translation during a period of unstable conditions in foreign exchange markets. Issuance of the 1931 report followed a period in which U.S. dollar exchange rates generally fell, and issuance of the 1934 report followed a period in which they generally rose. Both reports dealt primarily with methods of reporting gains and losses resulting from these changes in exchange rates.

The AICPA disbanded the special committee in 1938 and established the committee on accounting procedure, a larger and more permanent committee with authority to issue formal pronouncements on accounting principles. *Accounting Research Bulletin No. 4 (ARB 4)*, "Foreign Operations and Foreign Exchange," published in December 1939, was one of the earliest pronouncements of the new committee. It repeated substantially the previous recommendations of the special committee with particular emphasis on the desirability of conservative practices in reporting foreign earnings and consolidating foreign subsidiaries. The next significant AICPA publication on the subject appeared in 1950 when the Research Department of the Institute published a memorandum dealing with the effects on translation, consoli-

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[11] The report, titled "Foreign Exchange Losses," appeared in the *Bulletin of the American Institute of [Certified Public] Accountants No. 92,* December 15, 1931.

[12] The report, titled "Memorandum on Accounting for Foreign Exchange Gains," appeared in the *Bulletin of the American Institute of [Certified Public] Accountants No. 117,* January 11, 1934.

dation policy, and statement presentation of the widespread and substantial devaluations of the moneys of many countries in 1949.[13]

The pronouncement that is currently effective, Chapter 12 of *ARB 43*,[14] "Foreign Operations and Foreign Exchange," was issued in 1953 when the unsettling effects of World War II had not yet disappeared. It is essentially a restatement of *ARB 4* supplemented by the 1950 memorandum of the Research Department. Procedures recommended to translate long-term receivables and payables were modified in October 1965.[15] *ARB 43* as modified remains the most authoritative pronouncement on generally accepted accounting principles relating to foreign operations. Present generally accepted accounting principles for foreign operations can thus to a considerable degree be traced to the 1931 report of the special committee on accounting procedure which embraced the current-noncurrent method of translation.

The monetary-nonmonetary method is of more recent origin. Samuel R. Hepworth was the first to develop the method comprehensively, in the early 1950s.[16] However, credit for its development is probably more frequently given to a research report published in 1960 by the National Association of Accountants (NAA). Advocacy of the monetary-nonmonetary method by the NAA gave considerable impetus to its use in practice. A review of published annual reports by the Accounting Research Division of the AICPA revealed that at the time the NAA report was published most companies followed the current-noncurrent method, but since then a trend away from using that method has developed.[17] At the present time translation practice is largely a mixture of both the current-noncurrent and monetary-nonmonetary methods. Some companies use either method in unmodified form while other companies combine translation procedures from both methods in the same set of financial statements.

Another translation method that is sometimes used in accounting

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[13] "Accounting Problems Arising from Devaluation of Foreign Currencies," *The Journal of Accountancy*, January 1950, pp. 34-38.

[14] AICPA, *Accounting Research Bulletin No. 43*, "Restatement and Revision of Accounting Research Bulletins," 1953.

[15] AICPA, *Accounting Principles Board Opinion No. 6*, "Status of Accounting Research Bulletins," October 1965, par. 18.

[16] *Reporting Foreign Operations* (Ann Arbor: University of Michigan, 1956). The work was originally Professor Hepworth's doctoral dissertation and was written somewhere between 1951 and 1954.

[17] This observation was confirmed in a study by Anthony C. D. Choi, "Translation of Foreign Operations: a Survey," *Management Accounting*, April 1968, pp. 28-30.

practice in foreign countries translates all assets and liabilities at the foreign exchange rate in effect at the balance sheet date. That current rate method was recommended recently by the Council of The Institute of Chartered Accountants in England and Wales[18] and by the Research and Publications Committee of The Institute of Chartered Accountants of Scotland.[19]

Nature and Scope of Study

This study is primarily concerned with translating financial statements of foreign subsidiaries stated in foreign money into U.S. dollars to present general-purpose financial statements of U.S. companies. Since differences in foreign exchange rates create the major problem in translation, the solution to the problem involves (1) developing a basis for selecting among possible rates and (2) accounting for gains and losses that arise if more than one rate is used. Disclosing financial information about foreign operations is also discussed.

The study deals with financial information presented in general-purpose financial statements, not with information presented in financial

statements intended for management or taxing authorities. The study is written from the point of view of translating the financial statements of the foreign subsidiaries of a U.S. company into U.S. dollar financial statements, but the conclusions also apply to translating the financial statements of foreign investees accounted for under the equity method into U.S. dollars.[20]

The conclusions of the study should also generally apply to translating the financial statements of the U.S. subsidiaries of a foreign company into foreign money financial statements, but they do not necessarily apply to translation in other situations. For example, they may not apply to translating the financial statements of a foreign company that is not a subsidiary of a U.S. company or an investee accounted for under the equity method into U.S. dollars. The general problem of

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[18] "Accounting for Devaluation—Institute Recommendation on 'Accounting Treatment of Major Changes in the Sterling Parity of Overseas Currencies'," *The Accountant,* February 17, 1968, pp. 206-209.

[19] "The Treatment in Company Accounts of Changes in the Exchange Rates of International Currencies," *The Accountant's Magazine,* September 1970, pp. 415-423.

[20] AICPA, *Accounting Principles Board Opinion No. 18,* "The Equity Method of Accounting for Investments in Common Stock," March 1971, par. 17.

reporting in terms of one money the financial position and results of operations of an enterprise that measures them in terms of another money is beyond the scope of this study. Questions that pertain to whether foreign subsidiaries of U.S. companies should be consolidated, reported on the equity method, or reported at cost are also not specifically considered.[21]

[21] The Accounting Research Division of the AICPA has a study in progress on accounting for intercorporate investments which considers consolidation of foreign subsidiaries as part of the broader consolidation problem.

2

The Temporal Principle of Translation

An amount stated in foreign money in the financial statements of a foreign subsidiary is translated into U.S. dollars by multiplying it by a foreign exchange rate for the money. The chief problems in translation are to justify using foreign exchange rates to translate and to develop a principle to select the appropriate translation rate from among rates for the money that apply at different times. Justification for using foreign exchange rates and a principle to select rates that depends on the nature of translation are developed in this chapter.

Translation Changes the Unit of Measure

Financial accounting is commonly described as a measurement process.[1] If this description is to be taken seriously, its implications for translation should be examined. Measurements can be expressed in a number of different units. However, useful calculations can be made only with measurements expressed in the same unit; measurements expressed in different units must be converted to a single unit to permit useful calculations. Extending this observation to financial accounting, useful calculations can be made with financial accounting measurements expressed in different units of measure only if the measurements are first converted to a single unit.

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[1] For example, AICPA, *Accounting Principles Board Statement No. 4 (APB Statement 4)*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," October 1970, par. 120; American Accounting Association Committee to Prepare a Statement of Basic Accounting Theory, *A Statement of Basic Accounting Theory*, American Accounting Association, 1966, p. 1; Herman W. Bevis, *Corporate Financial Reporting in a Competitive Economy* (New York: The Macmillan Company, 1965), p. 93.

"The U.S. dollar is the unit of measure in financial accounting in the United States,"[2] and foreign moneys are the units of measure in financial accounting in foreign countries. Useful calculations can be made with financial accounting measurements that are expressed in the moneys of different countries only if the measurements are converted to a single unit of measure defined in terms of the money of a single country. Translation has therefore been properly defined as a measurement conversion process.[3] The definition of translation as a measurement conversion process follows from the nature of financial accounting as a measurement process, and that definition of translation is adopted in this study. No other definition of translation has been proposed in accounting literature, and no other is apparent.

U.S. companies state financial statements for their domestic operations in a unit of measure defined in terms of U.S. dollars; they state financial statements for their foreign subsidiaries in a unit of measure defined in terms of foreign money. Translation changes the unit of measure in the financial statements of foreign subsidiaries from one defined in terms of foreign money to one defined in terms of U.S. dollars. Although the term "conversion" describes changing a unit of measure better than the term "translation,"[4] "conversion" is also commonly used to mean the exchange of one money for another. To avoid confusing the two meanings, "translation" is used instead of "conversion" in this study.

Translation Changes No Other Accounting Principle

A measurement conversion process only changes the unit of measure; it cannot be used to change the attribute measured. Converting the

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[2] *APB Statement 4*, par. 166.

[3] "Translation is an accounting process in which amounts measured in one scale of measurement are converted to amounts stated in another scale of measurement by following the rules of translation. It is equivalent to conversion of amounts measured in the English scales of measurement to amounts stated in the metric scales—for example, inches to centimeters or ounces to grams. Units in two monetary scales, such as dollars and pounds, are related by the foreign exchange rate." Paul Rosenfield, "General Price-Level Accounting and Foreign Operations," *The Journal of Accountancy*, February 1971, p. 61.

[4] "Conversion" was used in *Accounting Research Bulletin No. 4*, "Foreign Operations and Foreign Exchange," issued in December 1939, but "translation" was used in the subsequently issued pronouncements.

measure of the width of a desk from inches to centimeters, for example, cannot result in a measure of the height of the desk. Changing the attribute measured is a separate process. Since translation is a measurement conversion process, it cannot change any of the accounting principles used in preparing the foreign money financial statements other than the unit of measure. Changing any other principle—for example, changing assets stated at historical cost to assets stated at replacement price—is a separate process. Translation is justified by the need to use a single unit of measure in consolidated financial statements. Changing any other principle is not translation and must be justified on other grounds.

A forceful illustration of the inability of translation to change principles of accounting other than the unit of measure is provided by financial statements of a foreign subsidiary in foreign money prepared in accordance with accounting principles generally accepted in the foreign country but not in the United States. No method of translation can consistently remove, for example, the effect of a tax valuation reserve on inventory for a Swedish subsidiary or the effect of revalorization of plant and equipment for tax and accounting purposes under a government-prescribed formula for a Venezuelan subsidiary. The only way to conform the statements of the subsidiary to accounting principles generally accepted in the United States is to conform them *before* they are translated into U.S. dollars. In fact, accounting principles that do not conform must be changed before translation to avoid producing translated financial statements that are prepared in conformity with accounting principles not generally accepted in the United States.

No more valid reason exists to change the principles used in preparing statements of foreign subsidiaries (other than to change the unit of measure and to conform to principles generally accepted in the United States) than to change the principles used in preparing the statements of the U.S. parent company and domestic subsidiaries. The question of whether the plant and equipment of foreign subsidiaries should be stated at replacement price in the consolidated statements, for example, cannot be answered without also answering the question of whether the plant and equipment of domestic subsidiaries should be stated at replacement price in the consolidated statements.

Changes in exchange rates affect the profits of U.S. companies that operate in foreign countries. Some of these effects are accounted for separately in the process of translation, as discussed in Chapter 5. Other effects are not accounted for separately in the process of translation but are instead accounted for jointly with the effects of other

events in determining the profits of the U.S. company in conformity with generally accepted accounting principles. A procedure that has been proposed to account separately for certain effects of changes in exchange rates is discussed in Chapter 4.

Translation Is Similar to General Price-Level Accounting

Translation is similar to general price-level accounting in two salient aspects. First, the unit of measure in financial statements is changed in both translation and general price-level accounting. Second, both translation and general price-level accounting change no other accounting principle used in preparing the financial statements. The unit of measure in financial statements is changed in general price-level accounting from one defined in terms of historical units of a country's money to one defined in terms of the general purchasing power of the unit of money at a specified date without changing any other accounting principle used in preparing historical-money financial statements:

> The same accounting principles used in preparing historical-dollar financial statements should be used in preparing general price-level financial statements except that changes in the general purchasing power of the dollar are recognized in general price-level financial statements.[5]

The Attributes of Assets and Liabilities Measured

The attributes of assets and liabilities that are measured under generally accepted accounting principles are discussed in this section to provide a foundation to develop a translation principle based on the attributes and the nature of translation as a measurement conversion process.

Assets and liabilities are to a significant extent measured at money prices—"ratios at which money and other resources are or may be exchanged"[6]—at specified dates. Assets stated at historical cost are measured at money prices in effect when they are acquired. Assets stated at current replacement price or current selling price are measured at money prices in effect at the balance sheet date. Obligations

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[5] AICPA, *Accounting Principles Board Statement No. 3 (APB Statement 3)*, "Financial Statements Restated for General Price-Level Changes," June 1969, par. 28.

[6] *APB Statement 4*, par. 70.

to deliver goods or services are measured at money prices in effect when they are recorded.

Some assets and liabilities are not measured at money prices. Money is measured at the quantity owned at the balance sheet date. Claims to money (receivables) and obligations to pay money (payables) are generally measured at the amount of money the debtor has promised to pay, although some receivables are measured at money prices; for example, bonds held as short-term investments may be measured at money prices in effect when acquired or at the balance sheet date under the cost or market rule.

Measuring Receivables and Payables. Measuring receivables and payables at the amounts promised is often interpreted as meaning that they are conceptually if not practically measured at the amounts of money that will be received or paid in the future. Thus, *APB Statement 4* states in paragraph 181 that payables are measured "at the amount of cash to be paid." *APB Statement 4* is even more explicit in interpreting receivables as measured at amounts of money that will be received. It states in paragraph 35 that receivables are measured at "net realizable value," and in a footnote to paragraph 70 states that "current selling price and net realizable value differ conceptually, although they may give the same amount under certain conditions," one of which is that "future sales price is expected to be the same as current sales price (or no better estimate of future sales price than current price is available)."

The interpretation in *APB Statement 4* that measuring receivables and payables at the amounts promised means measuring them conceptually at amounts of money that will be received or paid in the future is, however, inconsistent with the interpretation of the measurement of receivables and payables expressed in *APB Statement 3*. *APB Statement 3* states in paragraph 33 that receivables and payables "are stated in terms of current general purchasing power in historical-dollar statements" and should therefore be restated in general price-level accounting using the index number of the general price level applicable to the balance sheet date. If receivables and payables are measured conceptually at amounts of money that will be received or paid in the future, they are stated in terms of future, not current, general purchasing power in historical-dollar statements, and should presumably be restated using index numbers of the general price level applicable to the future dates that money will be received or paid. Differences in the amounts reported for receivables and payables in the restated financial statements that would result from restating the

expected amounts to be received or paid using different index numbers for different dates would therefore conceptually be corrections of estimating errors instead of general price-level gains and losses, which are defined as gains and losses that occur from holding monetary items while the general price level changes.

The interpretation in *APB Statement 4* that receivables and payables are measured at amounts of money that will be received or paid in the future is also not consistent with the principle of accepting evidence of "conditions existing at the balance sheet date" to measure receivables or payables but rejecting evidence of "conditions not existing at the balance sheet date" to measure them:

> For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance sheet date would be indicative of conditions existing at the balance sheet date, thereby calling for adjustment of the financial statements before their issuance. On the other hand, a similar loss resulting from a customer's major casualty such as a fire or flood subsequent to the balance sheet date would not be indicative of conditions existing at the balance sheet date and adjustment of the financial statements would not be appropriate.[7]

If receivables and payables are measured conceptually at amounts of money that will be received or paid in the future, all evidence is presumably acceptable to measure them regardless of whether it pertains to conditions existing after the balance sheet date.

The brief discussion in the preceding paragraphs shows that the interpretation placed by present generally accepted accounting principles on measuring receivables and payables at the amounts of money promised is not clear.[8] The confusion is essentially practical; that is, accountants give conflicting explanations of what they do in measuring receivables and payables. A clear concept would not only determine the time dimension of receivables and payables for translation purposes but would also guide practice in other areas of accounting. For example, a clear concept would determine the nature of auditing evidence instead of allowing rulings on auditing evidence to determine accounting principles.

In this study receivables and payables stated at the amounts prom-

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[7] AICPA, *Statement on Auditing Procedure No. 47*, "Subsequent Events," September 1971, par. 4.

[8] The Accounting Research Division of the American Institute of Certified Public Accountants has a study in progress on asset and liability valuation which considers this problem.

ised are presumed to be measured at money amounts that pertain to the balance sheet date instead of to the future date of receipt or payment. That presumption seems justified by interpretations in existing AICPA pronouncements of the way receivables and payables are measured, and it also avoids the practical problems that would arise in translation under the other presumption.

Summary of Attributes of Assets and Liabilities Measured. To summarize, the following attributes of assets and liabilities are measured under generally accepted accounting principles: money is measured at the quantity owned at the balance sheet date, receivables and payables stated at the amounts promised are measured at money amounts that pertain to the balance sheet date, and all other assets and liabilities are measured at money prices in effect at the balance sheet date or when the assets or liabilities were acquired or otherwise recorded in the accounting records.[9] A principle to translate can be developed from those characteristics of asset and liability measurement and from the fair value principle discussed next.

The Fair Value Principle

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An asset acquired in an exchange in which no money or claim to money is transferred is generally measured at a money price by using the fair value principle:

> Fair value is the approximation of exchange [money] price in transfers in which money or money claims are not involved. Similar exchanges are used to approximate what the exchange [money] price would have been if an exchange for money had taken place.[10]

The money price that would have been the basis for the exchange if an exchange for money had taken place is approximated "either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident."[11] The fair value of the consideration given or property acquired must be its fair value at the date of the exchange; the fair value at another date would not approximate a money price for the exchange.

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[9] *Statement on Auditing Procedure No. 47* seems to rule out the use of future money prices to measure assets and liabilities except in unusual circumstances.

[10] *APB Statement 4,* par. 181.

[11] AICPA, *Accounting Principles Board Opinion No. 16,* "Business Combinations," August 1970, par. 67.

The fair value principle can be used to approximate a money price, in terms of domestic money, for an exchange that does not involve domestic money but does involve foreign money and goods or services. The domestic money is "money" for the purpose of applying the fair value principle to the exchange; the foreign money involved in the exchange is not "money" for that purpose. The foreign money is either the "consideration given" or the "property acquired" depending on whether the exchange is a purchase or a sale (or the consideration bid or asked in a contemplated exchange). At the date of the exchange, the fair value in terms of domestic money of the consideration given or property acquired—the foreign money—is determined by the foreign exchange rate for the two moneys at that date. A domestic money price for the exchange can therefore be approximated by multiplying the foreign money price by the foreign exchange rate at the date of the exchange.

A different foreign exchange rate at a different date would not determine the fair value at the date of the exchange of the foreign money given or acquired, and would therefore not approximate a domestic money price for the exchange.

To illustrate, the historical cost (acquisition price), current replacement price, and current selling price of an asset may be stated in foreign money. The fair value principle may be used to approximate domestic money prices. Historical cost in domestic money is approximated by multiplying the historical cost in foreign money by the foreign exchange rate at the date of acquisition. Current replacement price and current selling price in domestic money are approximated by multiplying their counterparts in foreign money by the current foreign exchange rate.

The Temporal Principle of Translation

The nature of translation as a measurement conversion process requires that the assets and liabilities of foreign subsidiaries be translated in a manner that retains the accounting principles used to measure them in the foreign money financial statements; that is, that the attributes of the assets and liabilities measured be the same after translation as before. That objective is accomplished for assets and liabilities measured at foreign money prices by applying the fair value principle. A U.S. dollar price can be approximated for each foreign money price by multiplying the foreign money price by the foreign exchange rate in effect at the date to which the foreign money price pertains. The attributes measured—for example, his-

torical cost, current replacement price, or current selling price—are thus retained. Translating the assets and liabilities at the foreign exchange rate in effect at any other date or by using some other conversion factor results in restating the foreign money prices to U.S. dollar amounts that cannot be described as historical cost or current replacement or selling price, and consequently changes the principles used to measure them in the foreign money financial statements.

Foreign money and foreign money receivables and payables reported in foreign money financial statements cannot simply be translated; that is, their measurements cannot simply be converted from one unit of measure to another while retaining the attributes measured. The attributes of foreign money and foreign money receivables and payables measured in foreign money financial statements are the quantities of foreign money owned or promised. The quantity of an item can only be measured in a unit of measure defined in terms of that item. Other attributes of the item must be measured if the unit of measure is defined in terms of other items. Since the unit of measure is not defined in terms of foreign money in the translated financial statements, the quantities of foreign money owned or promised cannot be measured in those statements.

Another principle to measure foreign money and foreign money receivables and payables in the translated financial statements must therefore be adopted.

The attribute of foreign money of most interest from the perspective of the U.S. dollar financial statements is its command over U.S. dollars. The command over U.S. dollars of foreign money at a given time is determined by the foreign exchange rate for the two moneys at that time. Foreign money and foreign money receivables and payables stated at amounts promised should therefore be translated[12] into U.S. dollars at the foreign exchange rate in effect at the balance sheet date to measure their command over U.S. dollars at the balance sheet date. Translating them at the foreign exchange rate in effect at the balance sheet date retains the temporal characteristics of their measurement in the foreign money financial statements.

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[12] Strictly speaking, the term "translation" should not be used to describe measuring in terms of U.S. dollars foreign money and foreign money receivables and payables stated at amounts promised because measuring them in terms of U.S. dollars requires using a principle of measurement different from the principle used to measure them in the foreign money financial statements. The term "translation" is used in this study for convenience to describe their measurement in terms of U.S. dollars.

The preceding analysis justifies the requirement that foreign exchange rates be used in translation (1) to approximate U.S. dollar prices for assets and liabilities measured at foreign money prices and (2) to measure the command over U.S. dollars of assets and liabilities not measured at foreign money prices. The use of foreign exchange rates to translate in this manner can be summarized in a principle that may be called the *temporal principle* of translation because it depends on the temporal characteristics of asset and liability measurement:

> Money and receivables and payables measured at the amounts promised should be translated at the foreign exchange rate in effect at the balance sheet date. Assets and liabilities measured at money prices should be translated at the foreign exchange rate in effect at the dates to which the money prices pertain.

The dates that determine the foreign exchange rate used to translate under the temporal principle are the same as the dates that determine the index number of the general price level in the conversion factor used to restate in general price-level accounting. Money and receivables and payables stated at amounts promised are translated using the foreign exchange rate or restated using the index number applicable to the balance sheet date. Assets and liabilities measured at money prices are translated using the foreign exchange rate or restated using the index number applicable to the dates to which the money prices pertain.

3

The Temporal Principle Applied

The temporal characteristics of assets and liabilities determine the foreign exchange rates used to translate them under the temporal principle. A summary of important classes of assets and liabilities and the rates at which they are translated under the temporal principle is presented in this chapter, and the translation of certain items is explained.

Summary of Rates Used to Translate Assets and Liabilities

Assets and liabilities are translated under the temporal principle at the foreign exchange rate in effect at the balance sheet date (current rate) or at a foreign exchange rate in effect before the balance sheet date (past rate). The summary opposite shows the rates at which important classes of assets and liabilities are translated under the temporal principle.

Summary of Rates Used to Translate Assets and Liabilities

	Translation Rates	
	Past	*Current*
Assets		
Money		x
Marketable securities (stocks and bonds)		
Stated at cost	x	
Stated at current market price		x
Accounts and notes receivable		x
Allowance for doubtful accounts		x
Inventories		
Stated at cost	x	
Stated at current replacement price or current selling price		x
Stated at net realizable value (current selling price less cost to complete and sell)		x
Stated at contract price (produced under fixed price contracts)		x
Prepaid insurance, rent, taxes, advertising	x	
Investments in subsidiary companies		
Stated at cost	x	
Stated at equity (1)		
Goodwill (2)		
Property, plant, and equipment	x	
Allowance for depreciation (translated at the rates that apply to the translation of the related property, plant, and equipment)	x	
Deferred charges, including deferred charges for income taxes	x	
Patents, trademarks, licenses, formulas	x	
Liabilities		
Accounts and notes payable, accrued expenses		x
Bonds payable		x
Unamortized premium and discount on bonds payable		x
Obligations under capitalized leases		x
Accrued pension cost		x
Deferred income (measured at a money price in effect when it is recorded, and translated at the rate in effect at that date)	x	
Provisions for warranties		x
Deferred income tax credits (3)		

(1) See discussion on Translation Under the Equity Method.

(2) See discussion on Translation Following a Business Combination.

(3) See discussion on Deferred Income Tax Credits.

Translating Owners' Equity

Owners' equity of a foreign subsidiary is measured in terms of assets and liabilities and changes in them. It is a residual that is equal to the cumulative amount invested by owners plus cumulative net income (or less cumulative net loss) less the cumulative amount withdrawn by owners.

Investments and Withdrawals by Owners. Investments and withdrawals (including dividends) of foreign money should be translated at the foreign exchange rate in effect at the date of investment or withdrawal because the foreign money invested or withdrawn is translated at that rate at that date. Investments or withdrawals of other assets should be translated at the rate used to translate those assets.

Amounts invested by preferred stockholders should be translated in the same manner as amounts invested by common stockholders. Although the amount in foreign money reported for preferred stock might be interpreted as the present value of a perpetual annuity that consists of the fixed annual dividend, preferred stock is not now accounted for in that way. Preferred stock is accounted for solely in terms of the amount invested even though the amount invested may equal the present value of the perpetual annuity.

Net Income. Net income (net loss) is "the excess (deficit) of revenue over expenses for an accounting period."[1] Revenue consists of gross increases in assets or gross decreases in liabilities; expenses consist of gross decreases in assets or gross increases in liabilities "recognized and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities of an enterprise that can change owners' equity."[2] Translating the net income of a foreign subsidiary therefore requires translating the gross increases and decreases in its assets and liabilities that are reported as revenue and expenses.

Revenue or expenses recognized as a result of receiving or paying money or accruing receivables or payables is translated at the foreign exchange rate in effect at the date of recognition because money owned and receivables and payables are translated at that rate at that date.

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[1] AICPA, *Accounting Principles Board Statement No. 4 (APB Statement 4)*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," October 1970, par. 134.

[2] *Ibid.*

Revenue or expenses that include a large number of receipts or payments or accruals can usually be translated satisfactorily at approximated rates—for example, at an average rate—as discussed later.

An expense recognized as a result of shifting all or part of the amount reported for an asset to an expense category is translated at the rate that is used to translate the asset at the date of the shift. Revenue recognized as a result of shifting all or part of deferred income to a revenue category is translated at the rate that is used to translate the deferred income at the date of the shift. The revenue or expense is translated at a rate in effect earlier than the date the shift occurs if the asset or deferred income was acquired or recorded at an earlier date.

Expense or revenue reported as a result of writing the cost of an asset down or writing up an asset (when permissible) to current replacement or selling price is measured in dollars as the difference between the dollar amount reported for the asset at the current balance sheet date and the dollar amount reported at the previous balance sheet date. The expense or revenue can be translated into dollars by multiplying it by a single foreign exchange rate only if the asset was translated at the same rate in the previous balance sheet as it is in the current balance sheet. If different rates are used to translate the asset, the dollar amount of the revenue or expense equals the difference between the previous foreign money amount translated at the previous foreign exchange rate and the current foreign money amount translated at the current foreign exchange rate.

Retained Earnings and Capitalizations and Appropriations of Retained Earnings. Retained earnings of a foreign subsidiary in dollars is the cumulative amount of net income (loss) in dollars less the amounts in dollars of dividends and capitalizations or appropriations. Since specific increments in retained earnings are not capitalized or appropriated, an arbitrary method must be used to determine an amount in dollars at which to state retained earnings of foreign subsidiaries that are capitalized by issuance of stock or appropriated in their accounting records. One method is to translate the capitalized or appropriated amounts at the foreign exchange rate in effect at the date of capitalization or appropriation. Another method is to translate them at an average of the rates that were used to translate net income (loss) over the life of the subsidiary. The choice of rates affects only the dollar amounts reported for individual items of owners' equity for the foreign subsidiary; it does not affect the dollar amount reported for owners' equity in total.

Translation of Certain Items Explained

Translation of certain items under the temporal principle requires explanation. Translation of items at approximated past rates, translation of inventory under the cost or market rule, translation following a business combination, translation under the equity method, and translation of deferred income tax credits are discussed in this section.

Approximating Past Rates. Some financial statement categories that are translated at past foreign exchange rates include large numbers of items. In principle, a category should be analyzed into the components to which different rates apply and each component translated separately. This procedure is often unnecessary, however, because essentially the same result can often be obtained by translating at approximated rates.[3]

Approximated rates can be used to translate revenue and expenses that in principle are translated at the foreign exchange rates in effect at the dates at which they are recognized during the current period. If rate changes during the period are not significant, the revenue and expenses can be translated satisfactorily at a single representative rate for the period. The current rate or an average of month-end rates is commonly used in practice.[4]

If rate changes are significant during the period, the revenue and expenses should be grouped by subperiods—months, quarters, and so forth—and each group translated at a different foreign exchange rate. The rate used may be either an actual rate considered representative of all the rates for the subperiod or an average of actual rates. In practice, revenue and expenses are often grouped by month and translated at an average rate for each month.[5]

Inventories can also often be translated satisfactorily at approximated rates. Indeed, approximated rates are necessary to translate inventories stated at average cost. Fifo inventories that do not include depreciation expense may often be translated satisfactorily at the current rate if turnover is rapid. Overhead costs incurred in the re-

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[3] Similarly, approximation is often used in general price-level accounting to restate financial statement categories that include large numbers of items. AICPA, *Accounting Principles Board Statement No. 3 (APB Statement 3)*, "Financial Statements Restated for General Price-Level Changes," June 1969, Appendix C, Step 3.

[4] Anthony C. D. Choi, "Translation of Foreign Operations: a Survey," *Management Accounting*, April 1968, p. 30.

[5] *Ibid.*

porting period that are included in inventories can often be translated at approximated rates like revenue and expenses. Depreciation expense can also often be translated satisfactorily at approximated rates by translating depreciation on assets acquired during each year at a single representative rate for the year.

One suggested method to translate depreciation approximately consists of "expressing the depreciation allowance in dollars at the same proportion of the dollar cost as the foreign currency allowance is of the foreign currency cost."[6] That method of approximation produces different results from translation of the depreciation allowance on each asset item separately, however, if the asset items are acquired at times that different foreign exchange rates are in effect or if different ratios of accumulated depreciation to cost pertain to different asset items.[7] Since different plant and equipment items are commonly acquired at times that different foreign exchange rates are in effect and since the ratios of accumulated depreciation to cost commonly differ, the method probably seldom produces satisfactory translation results.

Applying the Cost or Market Rule. Inventory is stated under generally accepted accounting principles at cost or market price, whichever is lower. A problem in translation is that the cost or market rule may produce different results in the foreign money financial statements and in the translated financial statements. That is, market is higher than cost in terms of foreign money but lower than cost in terms of dollars if the market price in foreign money rises between the date of purchase and the balance sheet date and the foreign exchange rate falls in a proportionately greater amount. Conversely, market is lower than cost in terms of foreign money but higher than cost in terms of dollars if the market price in foreign money falls between the date of purchase and the balance sheet date and if the foreign exchange rate rises in a proportionately greater amount. To illustrate:

1. An inventory unit is purchased with £500 by a British subsidiary of a U.S. company when the foreign exchange rate for the pound is $2.40.
2. The inventory unit is still held on the next balance sheet date.

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[6] Samuel R. Hepworth, *Reporting Foreign Operations* (Ann Arbor: University of Michigan, 1956), p. 26.

[7] Allan R. Drebin, "A Fallacy of Depreciation Translation," *Journal of Accounting Research,* Autumn 1969, pp. 204-214.

3. The market price is £450.
4. The foreign exchange rate for the pound rises to $3.

Market and cost in terms of dollars and pounds are measured as follows:

Inventory	*Pounds*	*Translation Rate*	*Dollars*
At cost	500	$2.40	1,200
At market	450	$3.00	1,350

The cost or market rule should always be applied in the translated financial statements. Applying the rule only in the foreign money statements results in violating the rule in the translated statements if inventory is stated at market in the foreign money statements but market is higher than cost in dollars, as in the illustration, or if inventory is stated at cost in the foreign money statements but cost is higher than market in dollars. Chapter 12, paragraph 15 of *ARB 43* recommends that the rule be applied in the translated financial statements—a procedure which is similar to applying the rule in the restated financial statements in general price-level accounting.[8]

The cost or market rule should be applied in the translated financial
26 statements according to the principle stated in Chapter 4 of *ARB 43*, "Inventory Pricing." The principle requires comparing the cost, current replacement price, and net realizable value (current selling price less cost to complete and sell) of an inventory item in dollars. Dollar cost of an inventory item of a foreign subsidiary is obtained by translating foreign money cost at the rate in effect when the item is acquired; dollar replacement price is obtained by translating foreign money replacement price at the current rate; and dollar selling price is obtained by translating foreign money selling price at the current rate.

Translation Following a Business Combination. The method that a U.S. company uses to account for a foreign company that is acquired in a business combination determines the translation procedures to follow under the temporal principle. If a business combination is accounted for by the pooling of interests method, "the combined corporation records the historical-cost based amounts of the assets and liabilities of the separate companies because the existing basis of accounting continues."[9] A U.S. company that combines with a foreign

[8] *APB Statement 3*, par. 37.

[9] AICPA, *Accounting Principles Board Opinion No. 16 (APB Opinion 16)*, "Business Combinations," August 1970, par. 52.

company in a transaction accounted for by the pooling of interests method records the assets and liabilities of the foreign company in foreign money accounting records at the same amounts and on the same basis as they were recorded by the foreign company when it was a separate entity. The assets and liabilities of the foreign company acquired or incurred when it was a separate entity should therefore be translated as if the foreign company had always been a subsidiary of the U.S. company.

If a business combination is accounted for by the purchase method, "an acquiring corporation should allocate the cost of an acquired company to the assets acquired and liabilities assumed."[10] A U.S. company that acquires a foreign company with foreign money and accounts for the transaction by the purchase method assigns the foreign money cost to individual assets and liabilities (including goodwill and other intangibles). The dollar cost of the acquired company (the fair value of the foreign money cost at the date of purchase) should be assigned proportionately to those assets and liabilities in a translated balance sheet for the date of acquisition. The assets and liabilities acquired that are measured at historical cost in balance sheets for subsequent dates should be translated in those balance sheets into their dollar cost determined for the date of acquisition. Money and receivables acquired and payables assumed should be translated in balance sheets for subsequent dates at the foreign exchange rate in effect at those dates.

Translation Under the Equity Method. "The difference between consolidation and the equity method lies in the details reported in the financial statements."[11] A U.S. company that accounts for a foreign subsidiary or investee under the equity method obtains that result by treating the subsidiary or investee for translation purposes as a consolidated subsidiary and translating its financial statements under the temporal principle. A difference between the U.S. company's share of the translated net assets at the date of acquisition and the dollar cost of the investment should be "accounted for as if the investee were a consolidated subsidiary";[12] that is, it should be assigned to individual assets (including goodwill and other intangibles) in the translated balance sheet for the date of acquisition and amortized over the re-

[10] *Ibid.*, par. 87.

[11] AICPA, *Accounting Principles Board Opinion No. 18 (APB Opinion 18)*, "The Equity Method of Accounting for Investments in Common Stock," March 1971, par. 19.

[12] *Ibid.*

maining life of the assets.[13] The U.S. company's share of the translated net assets of the subsidiary (after allocation of the difference between cost and equity at the date of acquisition) should be reported in the consolidated balance sheet, and changes in that amount should be reported in the consolidated income statement.

Deferred Income Tax Credits. Some foreign countries may allow or require subsidiaries of U.S. companies to include certain revenue or expenses in determining taxable income in periods different from those in which the revenue or expenses are reported in financial statements prepared in conformity with accounting principles generally accepted in the United States. *Accounting Principles Board Opinion No. 11* requires interperiod income tax allocation using the deferred method for those timing differences.[14] Under the deferred method, "the tax effects of current timing differences are deferred currently and allocated to income tax expense of future periods when the timing differences reverse."[15] A deferred income tax credit is therefore not an obligation to pay money:

> The peculiarity of a deferred credit for taxes amid other deferrals is that its basis is neither a past nor an expected cash outlay or receipt. The deferred credit concept depends instead on the *absence* of a cash transaction. The internal logic of the deferred concept is that a future period is benefited because a company is *not* obligated to pay a given amount of income tax currently. An amount *not paid* is shifted from one period to another to attain a matching of expenses and revenue and an appropriate net income.[16]

Deferred income tax credits reported for foreign subsidiaries are measured in terms of payments of foreign money that are not made. They should be translated at the foreign exchange rates in effect when the income taxes that are not paid would otherwise have been paid, that is, when the deferral is recorded. A reduction in income tax expense recognized as a result of shifting all or part of the deferred credit to income tax expense is translated at the same rate that is used to translate the deferred credit at the date of the shift. That treatment of deferred income tax credits in translation is consistent with their treatment in general price-level accounting.[17]

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[13] *APB Opinion 16,* pars. 68-69.

[14] AICPA, "Accounting for Income Taxes," December 1967, pars. 13(a), 19.

[15] *APB Opinion 11,* par. 19.

[16] Homer A. Black, *Accounting Research Study No. 9,* "Interperiod Allocation of Corporate Income Taxes" (New York: AICPA, 1966), p. 49.

[17] *APB Statement 3,* Appendix B, p. 29.

4

The Temporal Principle Compared With Other Translation Methods

The temporal principle competes with several other methods of translation that have been used or proposed, and establishing the temporal principle as the sole basis for translating the financial statements of foreign subsidiaries depends on demonstrating its superiority over competing methods. The other translation methods with which the temporal principle is compared in this chapter are (1) translation based on the distinction between current and noncurrent assets and liabilities, (2) translation based on the distinction between monetary and nonmonetary assets and liabilities, (3) translation of all assets and liabilities at the current foreign exchange rate, and (4) translation of assets and liabilities at constructed rates instead of actual foreign exchange rates.

Current-Noncurrent Distinction

A U.S. company that uses the current-noncurrent distinction translates current assets and liabilities of foreign subsidiaries at the foreign exchange rate in effect at the balance sheet date (current rate), and translates noncurrent assets and liabilities at the foreign exchange rates in effect when the assets and liabilities were acquired or otherwise recorded in the subsidiary's accounting records (past rate). Some assets and liabilities are translated under present generally accepted accounting principles at the same rates under the current-noncurrent method as they are under the temporal principle, and others are translated at different rates. Those translated at the same rates are foreign

money, current assets and liabilities measured at the amounts promised, current assets and liabilities measured at current money prices, and noncurrent assets and liabilities measured at past money prices. Those translated at different rates are current assets and liabilities measured at past money prices and noncurrent assets and liabilities measured at the amounts promised.

The temporal principle differs from the current-noncurrent method most significantly under present generally accepted accounting principles in the translation of inventories and long-term debt. Inventory stated at historical cost is translated at the past rate under the temporal principle, but it is translated at the current rate under the current-noncurrent distinction. Long-term debt is translated at the current rate under the temporal principle, but it is translated at the past rate under the current-noncurrent distinction.

However, the committee on accounting procedure and the Accounting Principles Board introduced exceptions to the translation of inventories and long-term debt at the rates called for under the current-noncurrent distinction that produced the same translation results as those produced by the temporal principle. Chapter 12, "Foreign Operations and Foreign Exchange," paragraph 16, of *ARB 43*,[1] specified that an in-
30 ventory item should be stated in dollars by translating its cost by the past rate if that amount is less than net realizable value in dollars (selling price less disposal expenses translated at the current rate). Chapter 12, paragraph 18, of *ARB 43*, specified that long-term debt issued to acquire plant and equipment, permanent investments, or long-term receivables shortly before a substantial and presumably permanent change in the exchange rate may be translated after the change at the new rate. *APB Opinion 6*[2] approved translating long-term debt (and receivables) at the current rate "in many circumstances" without specifying circumstances in which the APB disapproved translation at the current rate.

Translating long-term debt and inventories at the rates called for under the current-noncurrent distinction, rather than the rates prescribed by the exceptions, produces results that cannot be meaningfully described except in terms of the calculations made to obtain them. To illustrate, long-term debt incurred by a Mexican subsidiary when the foreign exchange rate for the peso was $.08 and reported in the current

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[1] AICPA, *Accounting Research Bulletin No. 43,* "Restatement and Revision of Accounting Research Bulletins," 1953.

[2] AICPA, *Accounting Principles Board Opinion No. 6,* "Status of Accounting Research Bulletins," October 1965, par. 18.

balance sheet at a discounted amount of 1,000,000 pesos continues to be translated into $80,000 under the current-noncurrent approach after the foreign exchange rate for the peso rises to $.10. The $80,000 amount has little significance for restating the debt in dollars after the rise in rate. If the debt were discharged by a payment of 1,000,000 pesos at the balance sheet date, $80,000 would not be an acceptable alternative payment to both the debtor and the creditor. Although the debtor would undoubtedly be willing to pay $80,000 instead of 1,000,000 pesos, the creditor would be unwilling to accept less than $100,000. The only payment in dollars that would probably be acceptable to both parties is $100,000.

Similarly, an inventory item purchased by the subsidiary with 10,000 pesos when the foreign exchange rate for the peso was $.08 is translated under the current-noncurrent distinction into $1,000 after the foreign exchange rate rises to $.10. However, the $1,000 amount is not a measurement of the cost of the item in dollars. The cost of the item in dollars when acquired was $800, not $1,000, and subsequent changes in prices or foreign exchange rates do not change the historical cost or acquisition price of an asset already owned. Once it is recorded, the historical cost or acquisition price of an asset can be amortized or otherwise charged to expense in accounting records but cannot be changed because of varying prices without changing the basis of accounting from historical cost to something else. Nor is the $1,000 amount a measurement in dollars of the replacement or the selling price in pesos at the balance sheet date unless by coincidence the replacement or selling price in pesos at the balance sheet date happens to be 10,000 pesos.

The effect of translating the cost of the inventory item at the current rate is to write up its cost in dollars from $800 to $1,000. The amount of the write-up of $200 has no significance and cannot reasonably be described as a gain from the rise in the foreign exchange rate. The only dollar amount that pertains to the inventory item and that can reasonably be described as a gain from the rise in the foreign exchange rate is obtained by multiplying the *replacement* or *selling* price in pesos of the item at the date of the rate change by the change in rate. To illustrate, if the selling price of the item is 12,000 pesos at the date the peso rises from $.08 to $.10, the subsidiary has a gain of $240 because the command over dollars of the selling price of 12,000 pesos increases from $960 to $1,200 at that date. The gain is not reported under present generally accepted accounting principles, but it would be reported if generally accepted accounting principles were changed to require inventories to be consistently stated at current replacement or selling price. In the absence of a change in generally accepted accounting

principles, no way exists to report the gain in the process of translation. Translating the cost of the item in pesos at the new and old foreign exchange rates measures the dollar gain only by coincidence.

Although most accountants would probably agree that increasing the dollar cost of an inventory item through translation is inappropriate, some might argue that writing down the dollar cost is necessary if the exchange rate falls because the lower of cost and market rule applies and the selling price of the item in foreign money represents a command over fewer dollars after the fall in rate than before. For example, a fall in the exchange rate of pesos to $.06 would result in translating the inventory item by the current-noncurrent method into $600. However, the result is not a valid application of the cost or market rule for two reasons. First, since the historical cost in pesos translated at the current rate is neither the current dollar replacement price nor the current dollar selling price (except by coincidence), translating cost at the current rate cannot produce the amounts needed to determine market in dollars under the cost or market rule. Second, a write-down to market should be made solely in anticipation of a loss, not merely a lower profit margin on the sale of the item. The only practical way to determine the existence of a loss is to compare the dollar amount obtained by translating foreign money acquisition price or historical cost at the past rate with the dollar amount obtained by translating current foreign money replacement or selling price at the current rate. Translating foreign money acquisition cost at the current rate does not measure current market price in dollars, and a change in the exchange rate does not in itself justify writing dollar cost either up or down.

Existing definitions of current and noncurrent assets and liabilities contain nothing to explain why that classification scheme should determine the foreign exchange rates to be used to translate. The attributes of assets and liabilities that are measured in financial statements differ from the attributes of assets and liabilities that determine their classification as current or noncurrent. Consequently, different kinds of assets or liabilities may be measured the same way but classified differently or classified the same way but measured differently. For example, both inventory and plant and equipment are measured at historical cost, but inventory is classified as current and plant and equipment as noncurrent. Since translation is concerned with measurement and not with classification for purposes of disclosure, attributes of assets and liabilities that are not measured in financial statements but determine their classification for purposes of disclosure are irrelevant for selecting foreign exchange rates to translate.

Monetary-Nonmonetary Distinction

A U.S. company that uses the monetary-nonmonetary distinction translates monetary assets and liabilities of foreign subsidiaries at the foreign exchange rate in effect at the balance sheet date (current rate), and translates nonmonetary assets and liabilities at the foreign exchange rate in effect when the assets and liabilities were acquired or otherwise recorded in the subsidiary's accounting records (past rate). Both Hepworth and the National Association of Accountants (NAA), the principal developers of the monetary-nonmonetary method, defined monetary and nonmonetary assets and liabilities in essentially the same way but used different terminology. Hepworth defined "money-value" assets and liabilities as those that "represent a contractual right to receive or pay a fixed number of foreign currency units," and "non-money-value" assets and liabilities as those "the value of which may vary in terms of the foreign currency unit."[3] The NAA defined "financial" assets and liabilities as those that "represent a fixed number of foreign currency units," and "physical" assets and liabilities as those that have "the power to command increased selling prices."[4]

Under present generally accepted accounting principles, the monetary-nonmonetary method produces the same translation results as the temporal principle in the translation of monetary assets and liabilities and in the translation of nonmonetary assets and liabilities measured at past money prices. The monetary-nonmonetary method produces a different translation result from the temporal principle in the translation of nonmonetary assets and liabilities measured at current money prices—for example, inventory at current replacement price under the rule of the lower of cost and market.

The developers of the monetary-nonmonetary method made a significant contribution to translation practice in observing that monetary assets and liabilities are more reasonably translated at the current rate instead of the past rate regardless of whether they are classified as current or noncurrent. However, a comprehensive principle of translation cannot be derived solely from the monetary-nonmonetary distinction. One reason is that many assets and liabilities have both monetary and nonmonetary characteristics. For example, bonds and negotiable notes are contractual rights to fixed amounts of money (monetary character-

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[3] Samuel R. Hepworth, *Reporting Foreign Operations* (Ann Arbor: University of Michigan, 1956), p. 10.

[4] NAA, *Research Report No. 36,* "Management Accounting Problems in Foreign Operations" (New York: NAA, March 1960), pp. 16-17.

istic) but they also often have selling prices that can change (nonmonetary characteristic). Many bonds and notes therefore cannot be translated either as assets or as liabilities under the monetary-nonmonetary method unless the method is modified to require translation of these items according to whether the monetary or nonmonetary attribute is measured in the financial statements. However, modification of the approach to require translation according to the attribute measured leads to another difficulty. If the nonmonetary attribute is measured instead of the monetary attribute, bonds and notes measured at current market price would have to be translated at the rate in effect when they were acquired, producing translation results that cannot be meaningfully described except in terms of the computations made to obtain them.

The preceding discussion suggests another reason why a comprehensive principle of translation cannot be derived solely from the monetary-nonmonetary distinction: nonmonetary assets and liabilities are measured on more than one basis and translation at a past rate does not fit every basis. Translating nonmonetary items at a past rate produces reasonable results if the items are stated at historical cost in foreign money but not if they are stated at current market price in foreign money. The developers of the monetary-nonmonetary method have implied that nonmonetary items are measured solely on the basis of historical cost because they have contended that inventories that are measured at current market price are monetary items and therefore require translation at the current rate under the monetary-nonmonetary distinction:

> The use of replacement cost or "market" is, in fact, only an attempt to substitute a reasonably objective amount for the more elusive net realizable value. The immediate impact of this position is apparent. When net realizable value is adopted it is necessary to consider inventories as taking on the characteristics of money-value items, the value of which is a reflection of specific future cash inflows, and hence to bring the current rate of exchange into the translation process.[5]

That kind of reasoning does not adequately support translating inventories stated at current replacement price or net realizable value in foreign money at the current rate. The presumption that replacement price is a substitute for net realizable value may or may not be correct—a substantial literature maintains that replacement price is itself the

[5] Hepworth, *Reporting Foreign Operations,* p. 20.

right current market price and not merely a substitute for net realizable value. Even if the presumption is correct, however, inventory stated at net realizable value still has the attribute that makes it a nonmonetary asset—a selling price that can change—and inventory stated at net realizable value is accounted for at a changing selling price, not at a claim to a fixed amount of money. With the sole exception of inventory salable at a fixed contract price, inventory is nonmonetary; changing the way it is measured does not change that nature. Inventories salable at fixed contract prices are not really monetary assets either. Accountants may call them inventories but they account for the contract; that is, they treat them as "in effect receivables of a fixed amount."[6]

The developers of the monetary-nonmonetary method oversimplified the translation problem in that they believed that distinguishing between monetary and nonmonetary items was sufficient to solve the problem. They were apparently unaware that other criteria were also needed and that they themselves had introduced other criteria. Thus, they introduced the notion of "equivalent dollar cost" to explain why nonmonetary items should be translated at a past rate:

> As a basis for discussion, assume that a foreign subsidiary acquired a batch of merchandise at a cost of 30,000 foreign currency units at a time when the rate of exchange was ten foreign currency units to one dollar. The equivalent dollar cost of this merchandise is $3,000, a fact which cannot be changed by movements in exchange rates or replacement cost.[7]

However, the notion of equivalent dollar cost is derived from the fair value principle, not the nonmonetary attribute, and it does not specify a translation rate unless some other principle specifies that equivalent dollar cost is the desired result. Nonmonetary items have an equivalent dollar cost, but they also have an equivalent dollar replacement price, an equivalent dollar selling price, and an equivalent dollar net realizable value. The temporal principle specifies the equivalent dollar price that should be used to measure them in the translated financial statements according to whether they are measured at historical cost, current replacement price, current selling price, or net realizable value in the foreign money financial statements.

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[6] AICPA, *Accounting Principles Board Statement No. 3 (APB Statement 3)*, "Financial Statements Restated for General Price-Level Changes," June 1969, Appendix B.

[7] Hepworth, *Reporting Foreign Operations*, p. 20.

Current Rate for All Assets And Liabilities

Translation of all assets and liabilities of a foreign subsidiary at the current foreign exchange rate was recently recommended by the Council of The Institute of Chartered Accountants in England and Wales[8] and by the Research and Publications Committee of The Institute of Chartered Accountants of Scotland.[9] Translation at only the current rate differs from translation under the temporal principle and under the current-noncurrent and monetary-nonmonetary distinctions most significantly in that property, plant, and equipment are translated at the current rate only under the current rate approach.

Both the English and Scottish Institute groups also recommended a "historic rate" translation method. The historic rate method recommended by the English Institute group produces the same results as the current-noncurrent method, but the historic rate method recommended by the Scottish Institute group differs from the current-noncurrent method in that noncurrent liabilities are translated at the current rate.

Both Institute groups maintained that the choice between the current rate and historic rate methods depends on whether the domestic money is more or less "stable" than the foreign money in which the accounts of the foreign subsidiary are stated. The Scottish Institute group said that the current rate method "is not biased to the view that the domestic currency is necessarily the stable currency."[10] The English Institute group held that the historic rate method "measures overseas operations from the standpoint of a stable and unchanging home currency" and "may, for instance, sometimes be preferred where an overseas currency has a history of instability in relation to sterling."[11]

Apparently the two Institute groups considered the historic rate method preferable if the domestic money is more stable than the foreign money and the current rate method preferable if the foreign money is more stable than the domestic money. Nevertheless, the Scottish Institute group recommended the current rate method for translating assets and liabilities stated in terms of other moneys into sterling

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[8] "Accounting for Devaluation—Institute Recommendation on 'Accounting Treatment of Major Changes in the Sterling Parity of Overseas Currencies'," *The Accountant,* February 17, 1968, pp. 206-209.

[9] "The Treatment in Company Accounts of Changes in the Exchange Rates of International Currencies," *The Accountant's Magazine,* September 1970, pp. 415-423.

[10] "Treatment in Company Accounts," par. 13.

[11] "Accounting for Devaluation," Appendix, par. 14.

"except in unusual circumstances,"[12] whereas the English Institute group considered the use of the current rate method to translate assets and liabilities stated in terms of other moneys into sterling to be "a matter for judgement in the light of the facts of individual cases."[13]

Translation at the Current Rate and General Price-Level Accounting. The Council of the English Institute did not explain in the pronouncement what it meant by a stable money. However, the Research Committee of the English Institute, in a report issued contemporaneously with the pronouncement on translation, defined a stable money as one whose general purchasing power does not change,[14] and the term is defined in this way in other English accounting literature. Some English accountants interpreted the devaluation of the pound in 1967 to mean that the pound was less stable than the U.S. dollar because the fall in rate indicated that inflation was more severe in the United Kingdom than in the United States.[15]

The Scottish Institute group made another reference in the pronouncement to stable money:

> Special considerations arise when the parity rate of one particular currency is subject to frequent changes in terms of other more stable currencies. Two possible methods of dealing with such a problem are described in the Appendix.[16]

The Appendix elaborated further on the need for the two methods:

> Certain areas of the world have suffered chronic inflation in past years and some companies which operate internationally have devised accounting procedures to enable them to prepare financial

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[12] "Treatment in Company Accounts," par. 48.

[13] "Accounting for Devaluation," Appendix, par. 14.

[14] Research Committee of The Institute of Chartered Accountants in England and Wales, "Accounting for Stewardship in a Period of Inflation," August 1968, p. 5.

[15] One English accountant recommended after the 1967 devaluation that the financial statements of English companies be stated in U.S. dollars as a form of general price-level accounting because the devaluations of the pound since World War II indicated the dollar was a more stable money than the pound. Another English accountant disagreed because, he contended, the dollar was not a stable money either, and he cited statistics on inflation in the United States since World War II in support of his contention. D. R. Myddelton, "Council Dilemma on Currency Debasement," *Accountancy*, July 1969, pp. 490-491. P. D. Reynolds, *Accountancy*, September 1969, p. 703 (Letters to the Editor).

[16] "Treatment in Company Accounts," par. 5.

> statements for the subsidiaries operating in those areas in which the more serious effects of inflation are minimised. Two such procedures are described below and while both endeavour to deal with this problem their approaches are quite different.[17]

The first method is to record a "reserve for the exchange loss on net current assets" in the foreign money accounting records in the amount obtained by multiplying net current assets by the rate of inflation in the country where the subsidiary operates. The second method is to use the "local consumer price index" to restate the foreign money financial statements of the subsidiary for changes in the general price level and to translate the restated amounts at the current foreign exchange rate.

The preceding description indicates that the Scottish Institute group defined stable money in the same way as the statements of the English accountants which were described previously—that is, as money with a constant general purchasing power. For translating the assets and liabilities of a foreign subsidiary stated in a foreign money that is less stable than domestic money, the Scottish Institute group recommended translation of all assets and liabilities at the current rate with general price-level accounting in the foreign statements or translation at historical rates, as previously discussed. A reason the two alternative approaches were both recommended for the same circumstances was not given in the pronouncement but is suggested by the observation of the Scottish Institute group that both approaches produce the same translation result "if the devaluation [of the foreign money] became necessary as a consequence of inflation."[18] Since the Scottish Institute group asserted that "the rate of exchange will in the long term move in line with inflation,"[19] they apparently considered translation at historical rates to be an often satisfactory means of attaining essentially the same translation result produced by translating all assets and liabilities at the current rate in combination with general price-level accounting in the foreign statements.

To summarize, the Scottish Institute group apparently recommended in principle two translation methods: (1) translation of all assets and liabilities at the current rate in combination with general price-level accounting in the foreign statements, to be used for foreign subsidiaries that operate in countries where inflation is more severe than in the

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[17] "Treatment in Company Accounts," Appendix, par. 1.

[18] *Ibid.*, par. 25. Others have made the same observation—for example, Gerhard G. Mueller, *International Accounting* (New York: The Macmillan Company, 1967), pp. 196-197.

[19] "Treatment in Company Accounts," Appendix, par. 8.

United States; and (2) translation of all assets and liabilities at the current rate without general price-level accounting in the foreign statements, to be used for foreign subsidiaries that operate in countries where inflation is less severe than in the United States. The vague and confusing way in which the pronouncement of the Scottish Institute group is written precludes determining conclusively whether the preceding sentence correctly interprets the position of the Scottish Institute group, but that interpretation seems justified.

No reason can be inferred from the pronouncements of either the Scottish or English Institute groups why translating all assets and liabilities at the current rate with or without general price-level accounting in the foreign statements should be determined by the relative difference between inflation in the foreign and domestic countries, and no reason is apparent. Translation at the current rate in combination with general price-level accounting in the foreign statements is inappropriate as a means of accounting for inflation in foreign countries for reasons discussed elsewhere.[20]

In the United States, the basic consolidated financial statements should not be restated for general price-level changes.[21] The financial statements of foreign subsidiaries should be prepared for inclusion in supplemental consolidated financial statements restated for general price-level changes by translating the foreign money financial statements under the temporal principle and then restating the translated statements for changes in the general price level in the United States.[22]

Translating Plant and Equipment at the Current Rate in Statements Not Restated for General Price-Level Changes. The English and Scottish Institute groups emphasized the desirability of translating plant and equipment, especially that purchased on credit for which the liability incurred is outstanding, at the current rate in financial statements not restated for general price-level changes. The Scottish Institute group contended that translating plant and equipment at the past rate and the related liability at the current rate "suffers from a weakness in consistency"[23] that should be remedied by

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[20] Paul Rosenfield, "General Price-Level Accounting and Foreign Operations," *The Journal of Accountancy,* February 1971, pp. 58-65.

[21] *APB Statement 3,* par. 25.

[22] *APB Statement 3,* par. 45, states that the financial statements of foreign subsidiaries of U.S. companies should be restated for general price-level changes by using an index of the general level of prices in the United States.

[23] "Treatment in Company Accounts," par. 11.

translating both at the current rate. They gave an illustration in support of their conclusion in which equal amounts are reported for a plant item and its related liability in the untranslated foreign money statements of a subsidiary, but a lesser amount is reported for the asset than for the liability in the statements translated into sterling:

> It would appear from the balance sheet when converted to Sterling that the cover for the loan was insufficient. However, there has been no fundamental change in the relationship between the property and the secured loan.[24]

The preceding argument for translating plant and equipment at the current rate has two defects. First, consolidated financial statements are not intended to show "cover" of individual liabilities because consolidation obscures legal relationships, including that one. Since consolidated statements do not show "cover" of liabilities of the parent company and domestic subsidiaries, no reason is apparent to require them to show "cover" of liabilities of foreign subsidiaries. "Cover" of liabilities of foreign subsidiaries is shown by their financial statements stated in foreign money.

The second defect in the argument is that the "weakness in consistency" spoken of results solely from translating the asset at a different rate than the rate used to translate the liability. The inconsistency is avoided, therefore, by translating both the asset and the liability at any single rate—for example, the rate in effect when the asset was acquired and the liability incurred. Translation according to the current-noncurrent distinction thus avoids the inconsistency as well as the current rate method.[25]

Translating plant and equipment at the current rate following a fall in the foreign exchange rate results in writing off as a loss a portion of the acquisition cost. The Scottish Institute group recognized that a result of the current rate method "is to relieve future consolidated profits of depreciation equal to that loss."[26] They suggested a method to overcome that objection:

> It is possible to remedy this weakness if the devaluation became necessary as a consequence of internal inflation. In these circumstances the subsidiary may be able to adjust the value of its fixed

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[24] "Treatment in Company Accounts," par. 11.

[25] Translating assets at the rates used to translate related liabilities is discussed further in Chapter 5.

[26] "Treatment in Company Accounts," par. 24.

> assets so that it retains the sterling equivalent of the original written-down value [from depreciation charges] in its accounts.[27]

However, that proposal essentially invalidates the current rate method. A foreign subsidiary of a British company that "retains the sterling equivalent" of depreciated cost in substance translates plant and equipment at the past rate instead of the current rate and thus does not really follow the current rate method.

Translating plant and equipment at the current rate is fundamentally objectionable because it results in writing the cost of the assets up or down with changes in foreign exchange rates and consequently changes the basis of stating plant and equipment from the present generally accepted principle of historical cost. Translation at the current rate thus fails to achieve a basic objective of translation, which is to retain the bases on which financial statement items are stated under present generally accepted accounting principles. If a portion of the acquisition cost of plant and equipment is written off by translation at the current rate following a devaluation, the cost is not completely matched with the revenue to which it is related, and future periods' revenue are relieved of expenses that should be matched against them.

Plant and equipment are occasionally written down below their cost if net losses are expected:

> In unusual circumstances persuasive evidence may exist of impairment of the utility of productive facilities indicative of an inability to recover cost although the facilities have not become worthless. The amount at which those facilities are carried is sometimes reduced to recoverable cost and a loss recorded prior to disposition or expiration of the useful life of the facilities.[28]

However, a general rule to write down the dollar cost of the plant and equipment of foreign subsidiaries following devaluations should be avoided because most devaluations probably do not impair recoverable cost although they may occasionally result in lower profits. The temporal principle, not the current rate method, translates the cost of plant and equipment of foreign subsidiaries from cost in foreign money to cost in dollars. The recoverability of that cost should be examined just as the recoverability of the cost of the plant and equipment of domestic subsidiaries is examined. A major devaluation may provide

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[27] *Ibid.*, par. 25.

[28] AICPA, *Accounting Principles Board Statement No. 4 (APB Statement 4)*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," October 1970, par. 183.

some of the "persuasive evidence" required to demonstrate a loss of recoverable cost. Other evidence, however, is also required. And in any case, the amount of write-down on the cost of the asset obtained by translating its cost at the post-devaluation rate will equal the amount of the loss of recoverable cost in dollars only by sheerest coincidence.

Changes in Generally Accepted Accounting Principles That Justify the Current Rate Approach. Some accountants recommend translating plant and equipment stated at cost at the current rate to measure the dollar value of the assets. They define dollar value in different ways. For example, Seidler defines dollar value in terms of the "future earnings streams from the foreign subsidiary":

> It seems much more in accord with the contemporary emphasis on future earnings as a basis for investment valuation, to translate foreign accounts under a method which attempts to measure the effects of exchange rate changes on the *dollar value of the future earnings streams from the foreign subsidiary*. . . .
>
> In the case of the German revaluation [in 1969] the preponderance of evidence suggested that the *Deutsche mark value* of earnings in Germany from physical assets would remain reasonably constant, assuming no other factors unrelated to the revaluation occurred. There was no indication that the Deutsche mark value of these earnings might fall. Thus, with the revaluation a new, *higher level of dollar earnings* was established. It appears logical to reflect *these* circumstances by translating at an exchange rate which reflects both the constant Deutsche mark value of the earnings and the new dollar value: *the current exchange rate*.[29]

That argument for translating plant and equipment stated at cost at the current rate is a call to abandon the historical-cost basis of accounting. However, Seidler reaches the opposite conclusion:

> No doubt, the preceding few sentences raise the specter of "revaluation accounting" to some who accord certain deific properties to "Original Cost." To calm those believers, it should be noted that the restatement of the German assets to a higher dollar figure is not really a revaluation. Rather, it recognizes that the *original Deutsche mark cost* is now the more reasonable original cost figure of the *two* possibilities which exist; the American and the German.[30]

The conclusion that plant and equipment translated at the current rate is stated at historical cost in dollars is based on a misinterpretation

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[29] Lee J. Seidler, "An Income Approach to the Translation of Foreign Currency Financial Statements," *The CPA Journal* (formerly *The New York Certified Public Accountant*), January 1972, pp. 31-32.

[30] *Ibid.*, p. 32.

of the historical-cost basis of accounting. Under the historical-cost basis, plant and equipment are not written up or down in financial statements to reflect changes in estimates of future earnings. An asset purchased with German marks has an "original cost figure" in dollars calculated under the fair value principle at the dollar price of marks at the date of purchase. Changing that dollar amount in the translated statements changes the basis of accounting for the asset to something other than historical cost.

Seidler gives another reason for translating the cost of plant and equipment at the current rate: the asset will "still cost" the same amount in foreign money at the balance sheet date as it did at the date of purchase:

> The original DM 30,000 cost of the building represented a market estimate, at the date of acquisition, of the present value of its future earning power. There is no reason to expect any change in the Deutsche mark earning power of domestic German enterprises. One would be quite justified then, in assuming that the factory would *still cost* (depreciation excepted) DM 30,000. That revised cost, however, now represents U.S. $8,197 [after the exchange rate for the mark rose in 1969 from $.25 to $.27], which is $697 more than the original, equivalent dollar cost.[31]

The assumption that the current replacement price of an asset is the same as its historical cost is questionable except under the most restrictive conditions. Whether the current replacement price of an asset is the same as or different than its cost is not a matter to be assumed but a question of fact to be ascertained by investigating the market for the particular asset.

If the purpose of translating the plant and equipment of a foreign subsidiary is to measure the dollar value of the future earnings stream attributable to the asset or its replacement price in dollars, translating its cost at the current rate does not accomplish the purpose. Multiplying a historical cost of an asset recorded in foreign money at some past date by a current exchange rate does not produce an amount that can reasonably be described as the dollar value of the future earnings stream attributable to the asset or the current replacement price of the asset in dollars. The only way to measure the dollar value of the future earnings stream or the replacement price in dollars of the asset is to first state the asset in the subsidiary's foreign money financial statements at an estimate of the future foreign money earnings stream or at current replacement price in foreign money and then translate

[31] *Ibid.*, p. 29.

that amount at the current rate.[32] Translating the historical cost of an asset at the current rate measures the dollar value of future earnings or the replacement price in dollars of the asset only by coincidence.

Trying to change the basis of accounting by translating cost at the current rate demands too much of translation. That conclusion was reached by one accountant, for example, who proposed that all assets of foreign subsidiaries should be stated at replacement price in their foreign money financial statements and translated together with liabilities at the current rate.[33] The accountant recognized that the proposal is not simply translation but is "just one aspect of the much wider problem of choice between using historical costs and replacement costs."[34] The proposal is in fact consistent with the temporal principle because the assets and liabilities that are translated at the current rate are all measured at current foreign money prices.

The assets of foreign subsidiaries should be stated on the same basis as the assets of the U.S. parent company and domestic subsidiaries. Stating the assets of foreign subsidiaries on a different basis would prevent a meaningful consolidation of the foreign subsidiaries. The merits of stating the foreign and domestic assets of U.S. companies at replacement price or at another basis that is not presently accepted is beyond the scope of this study,[35] which is concerned with changing a measurement in foreign money into a measurement in dollars without changing the basis of the measurement. The temporal principle accomplishes this objective and can accommodate any conceivable basis of measurement that is based on dated exchanges.

Constructed Rate Approach

Another proposed translation approach is to use constructed rates instead of foreign exchange rates to translate. One proposal to use constructed rates was developed to translate the financial statements of foreign subsidiaries that are excluded from the consolidated state-

[32] A future exchange rate would be used at least in concept under the temporal principle to translate an estimate of a future foreign money earnings stream.

[33] R. H. Parker, "Principles and Practice in Translating Foreign Currencies: An Essay in Comparative Accounting," *Abacus*, December 1970, pp. 144-153.

[34] *Ibid.*, p. 152.

[35] The Accounting Research Division of the American Institute of Certified Public Accountants has a study in progress on asset and liability valuation which evaluates various bases of stating assets that have been proposed.

ments. The developer of the proposal described the kind of subsidiaries for which it was intended:

> Many U.S.-owned subsidiaries, located in countries such as Brazil, Argentina, and Chile, are insulated, because of exchange problems, from their parents. These companies continue to operate, and, hopefully, they will one day be brought back into consolidation with the U.S. parent. Important economic factors, such as inflation, plague such countries and the U.S.-owned subsidiaries operating overseas under these conditions. Many years may pass before conditions return to "normal," or at least to a condition of stability on a different plane. In the interim, the accounts become less meaningful under the impact of inflation.[36]

A series of rates is constructed for that purpose by multiplying the foreign exchange rate (in dollars) in effect at a selected base date by a series of ratios applicable to subsequent dates of an index number of changes in the general price level in the United States to an index number of changes in the general price level in the foreign country. The constructed rates are intended to approximate the foreign exchange rates that would have been in effect at the subsequent dates if the foreign exchange rate had "moved in tandem with the relative price structures of the two countries."[37] Translation at "official" foreign exchange rates administered by foreign governments is thus avoided:

> The exchange rate is an official statement of what a sovereign nation, perhaps in consultation with the International Monetary Fund, believes its own currency to be worth in terms of other currencies. Thus, the Argentina government has seen fit to restate its official peso exchange rate(s) many times over the years, as have other countries. There is often a considerable difference between these rates so stated by a government and the price structure within a country, that is, the changes in local price structure of a country are not necessarily expressed sympathetically and automatically in the current exchange rates.[38]

The Research and Publications Committee of the Scottish Institute also recommended translating at constructed rates to avoid translating at administered foreign exchange rates:

> When the rate of inflation within one country is not matched by a similar rate of inflation in other countries, the currency of the coun-

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[36] S. R. Sapienza, "Inflation and Foreign Investments," *Financial Executive,* April 1963, pp. 27-31. NAA, *Research Report No. 36,* p. 25, recommends an apparently similar approach.

[37] *Ibid.,* p. 29.

[38] *Ibid.,* p. 28.

> try suffering from the high rate of inflation will become over-valued in terms of those of other countries. In due course it will usually be necessary to devalue the former currency, and for this reason the relative rate of inflation may be considered as a guide to the likely movement in the rate of exchange of a country's currency.[39]

Financial statements of foreign subsidiaries restated for general price-level changes in the foreign country are translated at a constructed rate applicable to the balance sheet date as an alternative to translating them at the foreign exchange rate in effect at the balance sheet date. The constructed rate

> is the product of the official rate of exchange at that date [the balance sheet date] and the rate of inflation which has occurred since the last devaluation of the overseas currency. The latter rate avoids the problems raised by short-term divergencies between the rate of inflation and changes in the official rate of exchange and, on the basis that the rate of exchange will in the long term move in line with inflation, it is right to ignore these temporary fluctuations.[40]

Using constructed rates fails to achieve a basic objective of translation, which is to retain the bases on which financial statements are stated under present generally accepted accounting principles. The

amount obtained by multiplying historical cost or current replacement or selling price in foreign money by a constructed rate is not historical cost or current replacement or selling price in dollars. Historical cost or current replacement or selling price in dollars is obtained under the fair value principle by multiplying a foreign money price only by a foreign exchange rate at which foreign money and dollars actually are or may be exchanged. The fair value principle is always applied in practice to actual market prices and constructed market prices are never used as a substitute. Since the constructed rate approach changes the basis of accounting, it is not simply translation and requires separate justification.

The purpose of translating at constructed rates apparently is to avoid translating at foreign exchange rates that are kept by government participation in the foreign exchange market at levels different from those that would prevail in the absence of government participation. However, the developers of the constructed rate approach have not explained why translation at government-controlled rates should be avoided. Business enterprises often report government-controlled prices in their financial statements, and explanation is required as to

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[39] "Treatment in Company Accounts," Appendix, par. 6.
[40] *Ibid.*, par. 8.

why they should make an exception with foreign exchange rates. The statement that "the rate of exchange will in the long term move in line with inflation" suggests that a constructed rate is intended to approximate the foreign exchange rate that will be in effect in the future after the government becomes unable or unwilling to keep the foreign exchange rate at the previous level. If that interpretation of the purpose of translating at constructed rates is correct, the advocates of the approach have assumed (1) that financial statements of foreign subsidiaries should be translated in concept at future foreign exchange rates, and (2) that constructed rates are reasonably accurate approximations of future foreign exchange rates. Whether those assumptions are valid requires demonstration before the constructed rate approach can be considered acceptable.

Conclusions

The temporal principle was developed in this study from a definition of translation as a measurement conversion process in which the unit of measure is changed in the financial statements of foreign subsidiaries from one defined in terms of foreign money to one defined in terms of U.S. dollars. The alternative translation methods that are used in practice or have been proposed were not developed from a definition of translation and no real arguments have been given to support them. The current rate method is proposed virtually without explanation. The current-noncurrent method is derived from a classification scheme that is useful for a particular disclosure purpose but that is unrelated to the way assets and liabilities are measured in financial statements. The constructed rate method relies on the unsupported assertion that foreign exchange rates are not appropriate for translation because they are government controlled. The monetary-nonmonetary method is derived partly from a classification scheme that is indirectly related to the way assets and liabilities are measured in financial statements and partly from other criteria. The monetary-nonmonetary method can perhaps be described as an incomplete version of the temporal principle.

5

Foreign Exchange Gains and Losses

U.S. companies with foreign subsidiaries are exposed to a risk to which U.S. companies with no foreign subsidiaries are usually not exposed—the risk of changes in foreign exchange rates. Foreign subsidiaries whose financial statements are translated under the temporal principle report dollar gains and losses in their translated financial statements as a result of this risk; the gains and losses have no counterpart in their foreign money financial statements. The nature and measurement of the gains and losses and procedures to report them are the subject of this chapter.

Nature of Foreign Exchange Gains and Losses

If the foreign exchange rate does not change during a reporting period, no changes in net assets are reported in the translated financial statements of a foreign subsidiary that are not also reported in its foreign money financial statements. If the foreign exchange rate changes during a reporting period, a change in net assets is reported in the translated statements but not in the foreign money statements. The change in net assets reported solely in the translated statements is sometimes called a "translation adjustment"[1]—a description that implies the change is the result of some imperfection in the translation process. That description is misleading. The change in net assets is a gain or loss in command over dollars whose reporting is made possible by the translation process. The gain or loss is familiar to practically all managers of the foreign operations of U.S. companies, including those with no knowledge of the preparation of translated financial

[1] For example, Donald J. Hayes, "Translating Foreign Currencies," *Harvard Business Review*, January-February 1972, p. 12.

statements. Managers of foreign operations spend a great deal of time making financial arrangements that avoid "exposure" to the gain or loss, and numerous articles have been written suggesting financial arrangements for avoidance.[2] One common financial arrangement to avoid exposure is discussed in Chapter 6.

The gain or loss in command over dollars occurs because foreign money and foreign money receivables and payables are held by the foreign subsidiary while the foreign exchange rate for the money changes.[3] If the exchange rate for the money falls, the subsidiary's money and the money amounts that debtors of the subsidiary have promised to pay are worth fewer dollars than before the fall; on the other hand, satisfying the subsidiary's promises to pay money requires the sacrifice of fewer dollars than before the fall. The subsidiary consequently loses command over dollars from holding foreign money and foreign money receivables, and it gains command over dollars from holding foreign money payables as a result of the fall in rate. A rise in rate has the opposite effect.

The gain or loss is reported in the translated financial statements as the result of translating foreign money and foreign money receivables and payables stated at amounts promised at both the new and old foreign exchange rate. The gain or loss is not reported in the foreign money financial statements because the change in the foreign exchange rate does not change a quantity of foreign money owned or the amount of foreign money a debtor has promised to pay. Gains and losses in command over dollars reported in the translated financial statements as a result of holding foreign money and foreign money receivables and payables stated at amounts promised while the exchange rate changes are called "foreign exchange gains and losses" in this study.

Foreign exchange gains and losses are similar to general price-level gains and losses. General price-level gains and losses are reported as a result of holding dollars and holding receivables and payables in dollars stated at the amounts promised while the general price level changes. General price-level gains and losses are reported only in financial statements restated for general price-level changes. They are not reported in historical-dollar statements because changes in the

[2] For example, see Joseph E. Connor, "International Accounting," in *Financial Executive's Handbook*, Richard F. Vancil, Editor (Homewood, Illinois: Dow Jones-Irwin, Inc., 1970), pp. 1115-1119.

[3] A U.S. company with no foreign subsidiaries that holds foreign money or foreign money receivables or payables while the foreign exchange rate for the money changes similarly gains or loses command over dollars.

general price level do not change the number of dollars owned and do not change the number of dollars a debtor has promised to pay.[4]

A Broader Definition of Foreign Exchange Gains and Losses. Foreign exchange gains and losses are not the only kind of gain or loss that is reported in the translated financial statements but not in the foreign money financial statements of foreign subsidiaries under the temporal principle if the exchange rate changes during the reporting period. Changes in the replacement or selling price of assets measured consistently at current replacement or selling price in the foreign money financial statements are also reported solely in the translated financial statements if the foreign money replacement or selling price does not change while the exchange rate changes.[5] To illustrate, a British subsidiary that measures an inventory of an agricultural product at a current selling price of £1,000 while the rate for the pound rises from $2.40 to $2.60 reports a change in the selling price of the inventory solely in the translated financial statements.

An argument can be made that changes in replacement or selling price reported solely in the translated financial statements and changes in money owned and receivables and payables reported solely in the translated financial statements should be reported as a single category of gain or loss because of their similarities. Both kinds of gains and losses are caused by a change in a foreign exchange rate. The foreign money replacement or selling price is not fixed, and the amount of foreign money owned, claimed, or owed is also not fixed because money is spent, liabilities are paid, and receivables are collected or written off. If the foreign money replacement or selling price changes in the same instant in time that the exchange rate changes, the dollar gain or loss is the joint result of both the change in the foreign money replacement or selling price and the change in the exchange rate. Likewise, if the amount of foreign money owned, claimed, or owed changes in the same instant in time the exchange rate changes, the dollar amount of the change is the joint result of both the change in the

[4] AICPA, *Accounting Principles Board Statement No. 3 (APB Statement 3)*, "Financial Statements Restated for General Price-Level Changes," June 1969, pars. 17-18.

[5] Another kind of gain or loss reported solely in the translated financial statements results from applying the rule of cost or market, whichever is lower, in both the translated financial statements and the foreign money financial statements. If market is higher than cost in foreign money but lower than cost in dollars, inventory is written down to market solely in the translated statements, as discussed in Chapter 3.

foreign money amount and the change in the exchange rate.

Foreign exchange gains and losses are both similar to and different from changes in translated dollar replacement or selling prices reported solely in the translated financial statements, and deciding whether they should be reported together or separately in the translated statements on the basis of their similarities or differences is difficult. However, a precedent in general price-level accounting is available for classifying them separately. In general price-level accounting, changes in replacement or selling prices restated for general price-level changes and reported solely in the restated financial statements are reported separately from general price-level gains and losses in those statements.[6] Changes in translated dollar replacement or selling price reported solely in the translated financial statements should therefore be reported separately from foreign exchange gains and losses according to that precedent.

The question of whether changes in replacement or selling prices that are reported solely in translated financial statements or financial statements restated for general price-level changes should be reported separately from foreign exchange gains and losses or general price-level gains and losses requires further study. Regardless of whether the gains and losses are reported together or separately, they are still gains and losses and not "adjustments." Their mere classification does not change their nature.

Foreign Money Gains and Losses on Dollars Owned, Claimed, or Owed

A foreign subsidiary may own dollars or hold receivables or payables in dollars as a result of transacting business in the foreign country with dollars instead of foreign money as the medium of exchange. A foreign subsidiary that owns dollars or holds receivables or payables in dollars gains or loses command over foreign money while the exchange rate for the money changes, and it reports the gains or losses in its foreign money income statement. The subsidiary reports no dollar gains or losses in its translated income statement from owning dollars or holding receivables or payables in dollars while the exchange

[6] A few members of the Accounting Principles Board contended that the dollar gain or loss reported as a result of restating for a general price-level change the current dollar market price of foreign money owned by a U.S. company should be included with general price-level gains and losses. The majority of the APB disagreed. *APB Statement 3*, par. 22.

rate changes because it does not gain or lose command over dollars as a result of the rate change.

Measuring Foreign Exchange Gains and Losses

Foreign exchange gains and losses are conceptually measured directly under the temporal principle by multiplying the excess of foreign money and foreign money receivables stated at amounts promised over foreign money payables stated at amounts promised (net monetary assets) or the excess of foreign money payables stated at amounts promised over foreign money and foreign money receivables stated at amounts promised (net monetary liabilities) at the instant in time the foreign exchange rate changes by the amount of the change. Foreign money amounts reported in foreign money financial statements for dollars owned, claimed, or owed are excluded from the net monetary position in measuring the gain or loss. The conceptually correct amount is reasonably approximated by multiplying the net monetary position at the beginning or end of the day the exchange rate changes by the amount of the change. To illustrate, a British subsidiary with net monetary assets of £100,000 at the end of October 14 and £110,000 at the end of October 15 reports a foreign exchange loss of either $20,000 ($260,000 − $240,000) or $22,000 ($286,000 − $264,000) if the rate for the pound falls from $2.60 to $2.40 at October 15.

Foreign exchange gains and losses can be measured directly only if balance sheets for the foreign subsidiary are prepared for the date at or before which the foreign exchange rate changes. Since balance sheets are seldom prepared for those dates, direct measurement is generally impracticable. Foreign exchange gains and losses can be measured indirectly, however, at the amount required to make owners' equity equal net assets in the translated financial statements. The difference between owners' equity and net assets may also include other kinds of gains and losses than foreign exchange gains and losses, as discussed previously, and these should be classified separately.

Foreign exchange gains and losses can also be measured indirectly by adding to the net dollar monetary position at the beginning of the year the increases in the position during the year translated at the rate in effect when the increases occurred, and subtracting from this result the decreases in the position during the year translated at the rate in effect when the decreases occurred. The increases and decreases in the net monetary position during the year translated at these rates can be obtained from the schedules in which various balance sheet

and income statement items were translated in the process of preparing the translated balance sheet and income statement. The dollar amount resulting from adding and subtracting changes in the position during the year to the position at the beginning of the year is the net monetary position in dollars at the end of the year that would have been reported if no foreign exchange gain or loss had occurred. The foreign exchange gain or loss is calculated as the difference between this amount and the net monetary position in dollars at the end of the year reported in the translated balance sheet. A similar technique is used to measure general price-level gains and losses indirectly.[7]

The following schedule for a hypothetical foreign subsidiary illustrates the calculation of the foreign exchange gain or loss:

ABC Company Limited
Subsidiary of XYZ Company
Foreign Exchange Gain or Loss
Year Ended Dec. 31, 1971

	Foreign Money	*U.S. Dollars*
Net monetary liabilities—12/31/70—translated at the rate of $1.05 in effect at 12/31/70	553,000	581,000
Add:		
Purchases of inventory	2,284,000	1,899,000
Selling and administrative expenses	253,000	236,000
Income taxes	92,000	76,000
Dividends	24,000	20,000
Purchase of marketable securities	32,000	29,000
Purchase of property, plant, and equipment	100,000	105,000
Additions to prepaid expenses	3,000	3,000
	3,341,000	2,949,000
Deduct:		
Sales	2,986,000	2,564,000
Additions to deferred income	17,000	14,000
Proceeds from sale of equipment	10,000	9,000
	3,013,000	2,587,000
Net monetary liabilities—12/31/71	328,000	
Net monetary liabilities—12/31/71—calculated as if no foreign exchange gain or loss had occurred		362,000
Net monetary liabilities—12/31/71—translated at the rate of $.83 in effect at 12/31/71		(272,000)
Foreign exchange gain		90,000

[7] *APB Statement* 3, Appendix C, pp. 55, 67.

Reporting Foreign Exchange Gains and Losses as "Extraordinary Items"

The Accounting Principles Board recommended reporting as "extraordinary items" material gains and losses that result from "extraordinary events and transactions."[8] Extraordinary events and transactions

> are identified primarily by the nature of the underlying occurrence. They will be of a character significantly different from the typical or customary business activities of the entity. Accordingly, they will be events and transactions of material effect which would not be expected to recur frequently and which would not be considered as recurring factors in any evaluation of the ordinary operating processes of the business.[9]

The APB cited a "major devaluation of a foreign currency" as an example of an event that might be treated as extraordinary.[10]

The APB also stated that certain gains and losses, regardless of size, should not be reported as extraordinary items "because they are of a character typical of the customary business activities of the entity."[11] The APB cited "gains or losses from fluctuations of foreign exchange" as examples of gains and losses that might not be reported as extraordinary items.[12]

Changes in exchange rates are either extraordinary or ordinary events, and material foreign exchange gains and losses that result from them should be classified either as ordinary or extraordinary items under the APB criteria. Whether a rate change is ordinary or extraordinary does not depend on whether the money is kept at a set level by government action. Some devaluations and revaluations are ordinary rate changes whereas others are extraordinary; some rate changes for moneys that are not kept at a set level by government action are extraordinary rate changes whereas others are ordinary. For example, the Argentine peso was devalued by 13% in 1964, and the British pound was devalued by 14% in 1967. However, the 1967 devaluation of the British pound was the first devaluation or revaluation of the pound since 1949, and the rate did not change materially after that

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[8] AICPA, *Accounting Principles Board Opinion No. 9*, "Reporting the Results of Operations," December 1966, par. 17.

[9] *Ibid.*, par. 21.

[10] *Ibid.*

[11] *Ibid.*, par. 22.

[12] *Ibid.*

time until 1971; but the Argentine peso was devalued by 61% in 1962, 25% in 1965, 31% in 1966, and 42% in 1967. Although the pound was devalued in 1967 by approximately the same percent as the peso was devalued in 1964, only the devaluation of the pound qualifies as an extraordinary rate change.

The dollar rates for the moneys of some countries rose during 1971 over a period of several months to new official rate levels, as discussed in Chapter 1. Whether any or all of these rate rises qualify as extraordinary events requires determining whether a particular rate rise is unusual in comparison with rate rises in past years and whether a rise of that magnitude is "expected to recur frequently" in future years. In making the determination an accountant should keep in mind that after 1971 rates will be allowed to fluctuate 2¼% below and above the official rate instead of the 1% fluctuation previously allowed.

Deferring Recognition of Foreign Exchange Gains and Losses

Three procedures for deferring recognition of foreign exchange gains and losses are discussed in this section: a procedure that defers recognition of only gains and two procedures, one direct and one indirect, that defer recognition of both gains and losses. Deferral procedures in general are also discussed.

Deferral of Gains Only. The committee on accounting procedure recommended in Chapter 12 of *ARB 43* that "realized" and "unrealized" foreign exchange gains and losses be distinguished for income measurement:

> 10. Realized losses or gains on foreign exchange should be charged against or credited to operations.
>
> 11. Provision should be made, ordinarily by a charge against operations, for declines in translation value of foreign net current and working assets (unrealized losses). Unrealized gains should preferably be carried to a suspense account, except to the extent that they offset prior provisions for unrealized losses, in which case they may be credited to the account previously charged.

The committee apparently intended "unrealized" foreign exchange gains and losses to mean increases and decreases in translation value, but what they intended "realized" foreign exchange gains and losses to mean is not entirely clear. The committee provided at least a clue

in another paragraph of Chapter 12 that refers to "realization in dollars" of the earnings of foreign subsidiaries:

> 5. Any foreign earnings reported beyond the amounts received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant, and they should be reserved against to the extent that their realization in dollars appears to be doubtful.

The committee apparently considered that a gain or loss from holding foreign money or foreign money receivables while the exchange rate for the money changes is unrealized until the foreign money held or collected is used to pay dividends to the U.S. parent company. If the foreign money held or collected is used instead to purchase goods and services, however, the unrealized gain or loss that pertains to it apparently never becomes realized because it cannot reasonably be associated with foreign money dividends. Similarly, an unrealized gain or loss from holding foreign money liabilities while the exchange rate for the money changes apparently never becomes realized because it cannot reasonably be associated with foreign money dividends. Distinguishing realized and unrealized foreign exchange gains and losses is therefore seldom practicable.

The committee gave no reason why the deferral procedure should be used, but it was presumably intended to be conservative. However, the procedure is unconservative in the treatment of gains that "offset prior provisions for unrealized losses"; these gains are recognized when they occur even though they might be followed by losses. The procedure is extremely conservative in the treatment of gains that do not "offset prior provisions for unrealized losses"; recognition of most of these gains is deferred indefinitely because determining when they become realized is seldom practicable.

Direct Deferral of Both Gains and Losses. George C. Watt proposed a procedure under which recognition of both foreign exchange gains and foreign exchange losses is deferred in certain circumstances.[13] Gains and losses that pertain to net monetary asset positions are reported in the income statement for the period in which they occur. Recognition of a gain or loss that pertains to a net monetary liability position is deferred, but the amount of the gain or loss deferred is not to exceed the change in the exchange rate multiplied by

[13] "Unrealized Foreign Exchange Gains and Losses," *Management Accounting*, April 1968, pp. 31-38.

the amount of net property, plant, and equipment in foreign money. A gain or loss whose recognition is deferred is added to or deducted from a suspense account in the balance sheet.[14]

Recognition of a gain or loss that is added to or deducted from the suspense account is determined by comparing two amounts in dollars calculated for the net assets of the foreign subsidiary at subsequent balance sheet dates. The first amount is obtained by translating the net assets of the foreign subsidiary at the foreign exchange rates that apply under the monetary-nonmonetary approach (conventional net asset amount). The second amount is obtained by translating the net assets of the foreign subsidiary at the foreign exchange rate in effect at the balance sheet date (current rate net asset amount). The suspense account is treated as an asset or liability in calculating the conventional net asset amount but not the current rate net asset amount.

Following a devaluation, the conventional net asset amount under the procedure exceeds the current rate net asset amount at the end of the year of the devaluation after the entire amount of the gain is added to a suspense account. The difference between the two amounts decreases in following years as the portion of net assets translated at the old rate decreases because of depreciation, amortization, and sale. At the end of some year the conventional net asset amount is smaller than the current rate net asset amount. The suspense account is decreased in that year and in following years in an amount sufficient to keep the two net asset amounts equal. Decreases in the suspense account are reported as foreign exchange gains in the income statement.

Following a revaluation, the current rate net asset amount under the procedure exceeds the conventional net asset amount at the end of the year of the revaluation after the loss is added to a suspense account. The amount of the loss that is added to the suspense account in that year is not to exceed the difference between the two net asset amounts at the balance sheet date, and the portion of a loss that exceeds the difference is reported in the income statement for the year of the revaluation. The difference between the two net asset amounts decreases in following years, and the suspense account is reduced each year in an amount sufficient to keep it equal to their difference. Decreases in the suspense account are reported as foreign exchange losses in the income statement.

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[14] *Ibid.*, p. 37.

Watt contended that the procedure should be applied following a devaluation because

> there is no immediate prospect of liquidity of the unrealized gains until the fixed assets in the foreign country have in subsequent years proved their worth in the production of a product for sale at a price (usually an increased local currency selling price) covering the investment in fixed assets from the parent's point of view.[15]

Watt gave no reason why the procedure should be applied following a revaluation, but a reason was given by another accountant:

> The key question . . . is whether there is unrecognized U.S.-dollar appreciation in the nonmonetary assets arising from the upward currency revaluations in an amount sufficient to cover the recognized charge caused by the upward restatement of the net monetary liabilities. If such "cover" exists, no loss can realistically be said to have occurred, and, in my opinion, the charge should be deferred and amortized to future periods to match the recognized appreciation in the nonmonetary assets entering the income stream.[16]

Under the deferral procedure, a change in the dollar value of net monetary liabilities is offset against a change in the dollar value of nonmonetary assets. Since changes in the dollar value of nonmonetary assets are not recognized under generally accepted accounting principles, offsetting is accomplished by *not* recognizing changes in the dollar value of net monetary liabilities. The argument for deferral says in effect that changes in the dollar value of one item should not be recognized because changes in the dollar value of the other item are not recognized. However, if offsetting is accomplished at all, it should be accomplished by changing generally accepted accounting principles to recognize changes in the dollar value of *both* items. Accomplishing the offsetting by not recognizing changes in the dollar value of either item introduces an aberration into accounting for foreign operations that no accountant would tolerate for domestic operations. That aberration is the same as not recognizing a $1 million loss from embezzlement in California because the company owns land

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[15] George C. Watt, "Foreign Exchange Transactions and Translations," in *Handbook of Modern Accounting*, Sidney Davidson, Editor-in-Chief (New York: McGraw-Hill Book Company, 1970), Chapter 33, pp. 21-22.

[16] Donald J. Hayes, "Translating Foreign Currencies," p. 18.

in California worth $100 million that it bought for $10 million. The deferral procedure is an indirect way of applying current value or appraisal accounting to holdings in foreign countries.

Indirect Deferral of Both Gains and Losses. A procedure has been proposed to defer indirectly certain foreign exchange gains and losses—specifically, gains and losses on foreign money liabilities that finance assets held. The gains and losses are not reported as such. Instead, the costs of the assets are in effect adjusted by the amount of the gains or losses. Reporting the gains and losses is thereby deferred until the assets are sold or used.

The indirect deferral is accomplished in concept by translating the costs of the assets at the foreign exchange rates in effect when the liabilities are paid instead of at the rates in effect when the assets were purchased.[17] In practice, the procedure would be to translate the costs of the assets at the same rate as the liabilities (at the current rate under either the monetary-nonmonetary approach or the temporal principle). The proposal is similar to a recommendation of the committee on accounting procedure in Chapter 12, paragraph 12, of *ARB 43* that

> where fixed assets, permanent investments, or long-term receivables were acquired shortly before a substantial and presumably permanent change in the exchange rate with funds obtained in the country concerned . . . it may be appropriate to restate the dollar equivalents of such assets to the extent of the change in the related debt.

Although the effect is to defer the gains or losses, the procedure is not described or defended as a deferral procedure. The procedure is defended on the grounds that the cost of an asset is the amount ultimately paid for it, not the amount originally promised when the asset was acquired. Events affecting the liability after the acquisition of the asset affect the cost. Examples of events that would change the cost of assets include changes in foreign exchange rates, changes in the general level of prices,[18] and forgiveness of indebtedness.

The procedure should be rejected because it is based on a principle

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[17] E. Bruce Fredrikson, "On the Measurement of Foreign Income," *Journal of Accounting Research*, Autumn 1968, pp. 208-221.

[18] See Marvin M. Deupree, "Accounting for Gains and Losses in Purchasing Power of Monetary Items," Addendum to Appendix C of *Accounting Research Study No. 6*, "Reporting the Financial Effects of Price-Level Changes," pp. 153-165.

that is not and should not be generally accepted; namely, that the cost of an asset purchased on credit depends on events that affect the liability after the purchase date. The generally accepted principle is that the cost of an asset acquired is the exchange price at the date of acquisition and that the effects of events subsequent to acquisition on the asset and the liability are accounted for separately. The asset and liability are reported separately in the balance sheet. Revenue and expense items relating to the asset are reported in the income statement as operating items separate from revenue and expense items related to the liability, which are reported as financing items. The asset may be disposed of before the liability is paid or vice versa, but the accounting for the remaining item is unchanged; events affecting the remaining item are attributed to that item. The liability may be partially or wholly forgiven before or after the asset is disposed of, but the forgiveness does not affect accounting for the asset.

The Accounting Principles Board has affirmed the separation of accounting for assets and liabilities. It held that a change in a liability caused by inflation "accrues during the period of the general price-level increase and is unrelated to the cost of nonmonetary assets."[19]

60 Generally accepted accounting principles should not be changed to make cost of assets for accounting purposes depend on ultimate disposition of debt issued to finance the assets. First, exchange prices are in fact established by the acquisition transaction, and settlement of the debt is a separate economic event. Second, cost-based accounting would be destroyed by making cost depend on ultimate disposition of liabilities because cost would be an unknown and ever-changing amount. The most important advantage claimed for cost-based accounting is that cost is objective and verifiable because it is established by prices agreed to in transactions with outsiders. Perhaps cost-based accounting should be replaced by accounting based on current replacement prices or current selling prices, for example, but the traditional method should not be insidiously undermined by a change in principle that has neither theoretical nor practical merit except that it supports deferral of foreign exchange gains and losses on liabilities. If that is the route which must be followed to support deferral, deferral is an extremely questionable solution.

Deferral Procedures in General. Recognition of foreign exchange gains and losses should not be deferred under any procedure. Deferral procedures require either introducing into the balance sheet

[19] *APB Statement* 3, par. 17.

anomalous "suspense accounts" that qualify as neither assets nor liabilities or require attributing to assets changes in liabilities that affect neither the cost nor value of the assets. A deferral procedure results in reporting effects of exchange rate changes in the balance sheet but omitting to report them in the income statement. If a gain or loss on foreign exchange occurs, it should be reported consistently in both financial statements. If it does not occur, the balance sheet should not be made to report that it did. Reporting a foreign exchange gain or loss in one statement but not in the other means that the gain or loss is both denied and affirmed at the same time.[20]

The effects of exchange rate changes should be reported for both income statement and balance sheet purposes in the periods they occur. Deferral procedures result in an artificial smoothing of net income (because deferral must be arbitrary) that lessens the value of the information to financial statement readers. Financial analysts "prefer to see the earnings stated as they actually are, leaving the equalizing and averaging to be done by the stockholders, with the aid of their advisers."[21]

General price-level gains and losses are reported in the income statements for the periods in which they occur. No procedures are applied to defer their recognition until later periods.[22] Foreign exchange gains and losses are similar to general price-level gains and losses and should be treated the same way.

[20] Compare the following comment on a principle with a similar effect: "This result stems from the attempt to treat the transaction as though no sale has been made, insofar as the effect on net income is concerned, while treating the property as sold in the balance sheet." Maurice Moonitz, qualified assent to *Accounting Principles Board Opinion No. 5*, "Reporting of Leases in Financial Statements of Lessee," September 1964.

[21] Benjamin Graham, David L. Dodd, and Sidney Cottle, *Security Analysis—Principles and Technique*, Fourth Edition (New York: McGraw-Hill Book Company, 1962), p. 148.

[22] *APB Statement 3*, par. 41.

6

Concurrent Rates

Assets and liabilities of foreign subsidiaries are translated under the temporal principle at foreign exchange rates in effect at specified dates. Specification of the appropriate date does not completely solve the problem of selecting rates in translation, however, because concurrent rates prevail for every country's money. The concurrent rates discussed in this chapter are spot and forward rates, investment and dividend rates, and import and export rates.

Spot and Forward Rates

"Spot" rates quoted for a country's money at any date apply to exchanges of the money at that date. "Forward" rates quoted for a country's money at any date apply to exchanges of the money one or more months after that date.

Forward Exchange Contracts. A forward exchange contract is a written agreement to exchange moneys of different countries one or more months in the future. Business enterprises generally negotiate forward exchange contracts with banks. The rate specified in the contract—the forward rate—usually differs only slightly from the spot rate in effect at the date of the contract, and the amount of the difference depends on the length of the contract. Banks keep the difference small by establishing a network of forward exchange contracts within the banking system that enables them to avoid partially or completely the risk of changes in spot rates. Banks may be unwilling to negotiate forward exchange contracts if speculation in a country's money prevents them from successfully establishing a network.

Exporters and importers. U.S. companies that sell goods for export to customers in foreign countries or purchase goods for import from suppliers in foreign countries often negotiate forward exchange contracts at the time of sale or purchase. Exporters negotiate forward exchange contracts to sell foreign money that will be collected from export sales. Importers negotiate forward exchange contracts to buy foreign money that will be needed to pay for imported goods. Forward exchange contracts enable exporters and importers to establish at the date of sale or purchase the amount in dollars that will be received or paid. If the spot rate changes significantly between the date of sale or purchase and the date of collection or payment, the amount in dollars received or paid under the forward exchange contract differs significantly from the amount in dollars that would have been received or paid without the forward exchange contract. Exporters and importers consequently negotiate forward exchange contracts to avoid speculating on changes in spot rates.

Monetary positions of foreign subsidiaries. U.S. companies with foreign subsidiaries often negotiate forward exchange contracts to offset foreign exchange losses with gains on performance of the contracts. A U.S. company with a foreign subsidiary that has a net monetary asset position in a foreign money at the date the money is devalued incurs a foreign exchange loss. If the U.S. company previously negotiated a forward exchange contract to sell an amount of the money, it has an offsetting gain as a result of the devaluation because foreign money sold for future delivery at the forward rate is later purchased at the lower spot rate to fulfill the obligation.

A U.S. company with a foreign subsidiary that has a net monetary liability position in a foreign money at the date the money is revalued incurs a foreign exchange loss. If the U.S. company previously negotiated a forward exchange contract to buy an amount of the money, it has an offsetting gain as a result of the revaluation because foreign money purchased for future receipt at the forward rate is sold after receipt at a higher spot rate.

The gain on performance of the contract approximately offsets the foreign exchange loss if the amount of foreign money bought or sold at the forward rate equals the net monetary asset or liability position in the money at the date of devaluation or revaluation. The gain approximately offsets the loss because the difference between the forward rate specified in the contract and the spot rate at the date the contract is performed approximates the fall or rise in the spot rate. If the money is not devalued or revalued, the U.S. company incurs a

small loss instead of a gain on performance of the forward exchange contract but it incurs no foreign exchange loss.

To illustrate, a U.S. company has a British subsidiary with a net monetary asset position of £100,000 at October 1, 1967, when it could buy or sell pounds at a spot rate of $2.80. The U.S. company negotiates a forward exchange contract at this date to sell £100,000 at January 1, 1968, at a rate of $2.78. The pound is devalued in November 1967, and the U.S. company has a gain of $38,000 ($278,000 — $240,000) at January 1, 1968, from buying £100,000 at a spot rate of $2.40 and selling them at the rate of $2.78. If the subsidiary has the same monetary position at the date of devaluation as it has at October 1, the gain of $38,000 on performance of the contract approximately offsets the foreign exchange loss of $40,000. The U.S. company would have incurred a loss of $2,000 ($280,000 — $278,000) if no devaluation had occurred and the rate at which it bought pounds at January 1, 1968, were still $2.80.

Translating at Spot Rates. Spot rates are used in practice to translate the assets and liabilities of foreign subsidiaries of U.S. companies

that have no unperformed forward exchange contracts at the balance sheet date. The committee on accounting procedure recommended translating assets and liabilities at spot rates in Chapter 12, "Foreign Operations and Foreign Exchange," paragraph 14, of *ARB 43*,[1] but it implied that forward rates should be used to translate some assets if the U.S. company had unperformed forward exchange contracts at the balance sheet date:

> Cash, accounts receivable, and other current assets, unless covered by forward exchange contracts, should be translated at the rate of exchange prevailing on the date of the balance sheet.

Under the temporal principle, assets and liabilities of foreign subsidiaries should be translated at spot rates regardless of whether the U.S. company has unperformed forward exchange contracts at the balance sheet date. An asset or liability measured at a foreign money price in effect at a specified date is restated under the temporal principle to a dollar money price at the same date. Translating the asset or liability at a spot rate in effect at the date of the money price restates it to a dollar money price at the same date, but translating it

[1] AICPA, *Accounting Research Bulletin No. 43*, "Restatement and Revision of Accounting Research Bulletins," 1953.

at a forward rate in effect at the date of the money price restates it to a dollar money price at a later date.

Some accountants might argue that a U.S. company with an unperformed forward exchange contract to sell foreign money should translate at the forward rate specified in the contract an amount of cash and receivables in the money that will be collected before the date of performance equal to the amount of money in the contract. These accountants might argue that translating those assets at the forward rate measures their realizable value in dollars. The money of foreign subsidiaries is generally not delivered under forward exchange contracts, however, and a U.S. company that intends to deliver money of foreign subsidiaries may change its intentions before delivery is made. All assets should therefore be translated at spot rates.

Reporting Unperformed Forward Exchange Contracts. Although George Watt did not recommend translating at forward rates, he recommended "accruing" gains on unperformed forward exchange contracts:

> There are a number of ways of hedging against foreign exchange fluctuations. Where hedging devices of any type are in existence, extreme care is necessary to avoid arbitrary shifting of (possibly nonexistent) exchange gains and losses among years.
>
> For example, if a company has sold pesos short 90 days and the peso is devalued during the 90-day period, the unrealized gain on the incomplete hedging transaction should be accrued and taken into income to the extent of any unrealized exchange loss resulting from translation of accounts subsequent to the devaluation.[2]

Forward exchange contracts are similar to firm purchase commitments for goods for inventory and commodity futures contracts in that all are agreements to exchange resources in the future at a price set in advance. In practice, losses (but not gains) are generally recorded on unperformed purchase commitments for goods for inventory,[3] and both losses and gains are often recorded on unperformed commodity futures contracts.[4]

Recognizing gains on unperformed forward exchange contracts should depend on whether the contracts represent economic resources

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[2] "Foreign Exchange Transactions and Translations," in *Handbook of Modern Accounting,* Sidney Davidson, Editor-in-Chief (New York: McGraw-Hill Book Company, 1970), Chapter 33, p. 28.

[3] *ARB 43,* Chapter 4, "Inventory Pricing," Statement 8.

[4] Kathryn Current, "Hedging as an Aid in Inventory Cost Control," *Management Accounting,* October 1966, Section 2, p. 50.

or economic obligations[5] that should be reported as assets or liabilities. An unperformed forward exchange contract is in one sense both a resource and an obligation—the U.S. company has a claim to dollars (foreign money) and an obligation to deliver foreign money (dollars). Reporting an unperformed forward exchange contract as both an asset and a liability is, however, contrary to the generally accepted accounting principle of not recording executory contracts:

> Resources and obligations that result from executory contracts are generally not recorded as assets and liabilities until one of the parties at least partially fulfills his commitment.[6]

U.S. companies often assign their rights and obligations under an unperformed forward exchange contract to a bank after a devaluation or revaluation and receive as consideration an amount in money equal to the anticipated gain less a discount. Unperformed forward exchange contracts consequently often have market prices and are economic resources. The resource is acquired in the reciprocal transfer of promises between the enterprise and the bank that issues the contract. The difference between the forward and spot rates at the date of the contract is sometimes referred to as the "cost" of the contract, but it is not

a cost in the sense of an obligation to pay the bank for servicing the contract. The bank earns a profit not by charging the customer but by selling to another customer at a higher price the foreign money it buys under the contract.

That a forward exchange contract has no cost in the ordinary sense of the word is insufficient reason for not reporting it as an asset. An unperformed forward exchange contract with a market price should be reported as an asset and stated at the market price.

Investment and Dividend Rates

Almost all foreign moneys are traded concurrently at two spot rates: a "buying" rate and a "selling" rate. A U.S. company exchanges foreign money for dollars in the United States at the "buying" rate for foreign

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[5] Economic resources are "the scarce means (limited in supply relative to desired uses) available for carrying on economic activities." Economic obligations are "present responsibilities to transfer economic resources or provide services to other entities in the future." AICPA, *Accounting Principles Board Statement No. 4 (APB Statement 4)*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," October 1970, pars. 57-58.

[6] *APB Statement 4*, par. 162.

money but in foreign countries at the "selling" rate for dollars. It exchanges dollars for foreign money in the United States at the "selling" rate for foreign money but in foreign countries at the "buying" rate for dollars. Clarity is attained by adopting other terms for the two rates because the terms "buying" and "selling" apply to the same exchange by a U.S. company depending on where it is made. Since a U.S. company exchanges dollars for foreign money to invest in a foreign subsidiary and it exchanges foreign money dividends from the subsidiary for dollars, the terms "investment" and "dividend" rates are used instead of the terms "selling" and "buying" rates in this study.

The investment rate is generally higher than the dividend rate expressed in dollars, and the dividend rate is generally higher than the investment rate expressed in foreign money. The spread enables U.S. and foreign banks to cover expenses and earn a profit on exchanging moneys. The spread is generally less than 1%, but a few foreign governments impose taxes on exchanges that increase the spread.[7]

The choice between the two rates for translation has been almost ignored in accounting literature, probably because the difference between them is usually insignificant. Most writers have acknowledged the existence of only one rate. Chapter 12, paragraph 14, of *ARB 43*, for example, stated that current assets should be translated "at the rate of exchange prevailing on the date of the balance sheet." On the other hand, paragraph 12 stated:

> When large items are purchased for United States dollars (or from the proceeds of sale of such dollars), the United States dollar cost will, of course, be used.

A "large item" purchased with the foreign money proceeds from a "sale" of dollars and recorded at the amount of these proceeds has to be translated at the investment rate in effect at the date of purchase to produce the translation result recommended in *ARB 43*.

Accountants who have recognized the existence of the two rates differ on how to use them in translation. The March 1972 issue of *The Lybrand Newsletter* (page 4) recommended translating at the mean of the two rates in the absence of a "meaningful" official rate, but it gave no reason for its choice. George Watt recommended translating at the dividend rate but gave no reason for his choice either.[8] Hep-

[7] For example, the United Arab Republic imposed a tax of 5% on dividend exchanges in 1970. *International Financial Statistics* (Washington, D. C.: International Monetary Fund, March 1971), p. 340.

[8] *Handbook of Modern Accounting*, 1970, Chapter 33, p. 10.

worth presented an argument for translating at a "financial" instead of a "commodity" rate, but the argument also supports translating at the dividend rate instead of the investment rate:

> . . . it is desirable to consider that the fundamental attribute of value of an asset element (or the negative value of a debt) is represented by the present value of the future cash receipts which the asset is capable of producing. If we apply this concept to the problem at hand, it follows that the most satisfactory measure of the dollar value of foreign currency net assets should be the present value of the future dollar receipts produced thereby. Quite apparently it is impossible to apply such a rigorous theoretical concept in a practical situation. However, this valuation concept would seem to lead to the use of a rate of exchange which was related to the flow of dollar receipts from the foreign subsidiary. In turn, this reasoning would suggest the use of a financial rate as being productive of the most rational results in terms of the dollar value of foreign net assets. . . . for this reason the use of an exchange rate related to the remittance of earnings from the foreign subsidiary for the purpose of translating foreign currency accounts is recommended.[9]

The dividend rate should generally be used to translate. Foreign money should be translated at the dividend rate to measure the amount of dollars for which it can be exchanged. All other assets and liabilities should also be translated at the dividend rate to make their translation consistent with the translation of foreign money. Translating some or all of them at the investment rate results in reporting meaningless gains and losses in the translated financial statements when business is transacted by the foreign subsidiary. Translating liabilities and receivables at the investment rate and cash at the dividend rate, for example, results in reporting a gain when a liability is paid and a loss when a receivable is collected. Translating liabilities at the dividend rate and nonmonetary assets at the investment rate results in reporting gains when assets are purchased on credit. These results are undesirable and are avoided by translating all assets and liabilities other than money at the rate used to translate money—that is, at the dividend rate.

Dollar Transactions. Foreign subsidiaries which have assets and liabilities that are monetary in terms of dollars or which have assets that were purchased with dollars measure these assets and liabilities

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[9] Samuel R. Hepworth, *Reporting Foreign Operations* (Ann Arbor: University of Michigan, 1956), pp. 129-130.

in terms of foreign money in their foreign money financial statements. They should translate them at either the dividend or the investment rate, depending on which rate produces the fixed monetary amount in dollars or purchase price in dollars. Foreign subsidiaries in practice often keep subsidiary records in dollars for the assets and liabilities and state the assets and liabilities in the translated financial statements at the dollar amounts in the subsidiary records.

Foreign subsidiaries may have assets that were purchased with foreign money obtained in an exchange for dollars—for example, plant and equipment acquired with the proceeds of an investment by the U.S. parent company. They should translate the foreign money cost recorded for the assets at the investment rate at the date of purchase to produce the amount of dollars transferred in the exchange. The assets are in substance purchased with dollars and should be measured in the translated financial statements at the amount of dollars transferred.

Dual Dividend Rates. Some foreign countries control the payment of dividends by subsidiaries of U.S. companies that operate in the country. One control scheme that is sometimes used consists of establishing dual dividend rates. A dividend payment not exceeding a specified amount is exchanged at one of the two rates; dividend payments in excess of the specified amount are exchanged at the other rate.[10]

An argument might be made that U.S. companies should translate the financial statements of foreign subsidiaries subject to dual dividend rates at an effective dividend rate calculated on the basis of expected future dividends. Translation at an effective dividend rate is undesirable, however, for two reasons. First, estimates of future dividends are unreliable. Second, the dividend policies of foreign subsidiaries are determined in part from interpretation of their U.S. dollar financial statements. The amounts in these statements depend on the foreign exchange rates used in translation, which in turn would be dependent on the dividend policy of the subsidiary. If the U.S. dollar statements are to be used in determining dividend policy, however, they should not at the same time be a product of it.

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[10] During 1967 in Ecuador, for example, a subsidiary of a U.S. company had to pay dividends equal to 12% of "registered capital" at a controlled "official" rate but was allowed to obtain dollars to pay dividends in excess of that amount at the "free market" rate under certain circumstances. *Nineteenth Annual Report on Exchange Restrictions* (Washington, D. C.: International Monetary Fund, 1968), p. 133.

Only the rate applicable to the basic amount of dividends should be used to translate. Some dividends are always exchanged at this rate, but none may ever be exchanged at the other rate, especially because governments of countries with dual rate systems tend to set basic amounts quite high.

Import and Export Rates

Some foreign countries control all transactions that involve the exchange of dollars for the money of the country. One control system that has been used by a few countries consists of establishing exchange rates for import and export transactions that differ from the rates established for investment and dividend transactions. The different rates are established to favor the transactions that are considered most beneficial to the country. The countries that have used these multiple exchange rate systems have typically adopted and abandoned them frequently.

Colombian Multiple Rate System in 1967. The multiple exchange rate system that was used in Colombia in 1967 is a good example of a common type of system. The system was designed to reduce Colombia's dependence on the export of coffee and petroleum products by providing incentives to export other products. The table opposite shows the various buying and selling rates for U.S. dollars in the two official markets at December 31, 1967.

The "capital market" buying rate of 16.25 pesos was the investment rate and the "capital market" selling rate of 16.30 pesos was the dividend rate. The "certificate market" buying rate of 18.12 pesos applied to most exports and the "certificate market" selling rate of 15.82 pesos applied to most imports. The unusually large difference between the two "certificate market" buying and selling rates reflected a government subsidy in the form of a tax credit.

The certificate market was used by exporters and importers who bought and sold "exchange certificates" instead of dollars from each other in this market. The Bank of the Republic issued the exchange certificates to exporters and redeemed them from importers. An exporter was required to surrender the dollar proceeds of his export sales to the Bank in return for exchange certificates in the amount surrendered. An importer received dollars at the Bank in the amount of his certificates after proving that the dollars would be used to pay for goods whose importation was approved by the government. The Bank used a specified amount of the dollars surrendered by exporters to

Table of Exchange Rates
(as at December 31, 1967)

(pesos per U.S. dollar)

Buying	*Selling*
	9.00 (*Fixed Rate*) Purchases of crude oil from foreign-owned companies for domestic refining.
12.14 (*Certificate Market Rate less 23%*) Coffee exports.	
15.76 (*Certificate Market Rate, Fluctuating Rate*) Net proceeds from exports of crude oil and petroleum derivatives by Ecopetrol (Article 158 of Decree-Law No. 444).* Exports of cattle hides. Loans to public entities.	**15.82** (*Certificate Market Rate, Fluctuating Rate*) Imports except those into free ports. Expenses of students sponsored by ICETEX. Official services. External public debt. Service on (1) private obligations in foreign exchange contracted at the free market rate prior to October 25, 1964 and registered in accordance with Article 28 and following of Decree No. 2322 of September 2, 1965, and (2) private loans whose proceeds were sold to the Bank of the Republic according to Article 33 of that decree.
16.25 (*Capital Market Rate, Fixed Rate*)* Exports from free ports. Private loans. Invisibles. Exchange sales by foreign petroleum companies. Other foreign capital. Repatriation of Colombian capital and of profits accruing to Colombian capital abroad.	**16.30** (*Capital Market Rate, Fixed Rate*) Imports into free ports. Import freight. Other invisibles. Other foreign debt. Profit remittances and capital repatriation.
18.12 (*Certificate Market Rate plus 15% Tax Credit Certificates*) All other exports except those from free ports.	

Source: International Monetary Fund, *Nineteenth Annual Report on Exchange Restrictions* (Washington, D.C., 1968), p. 101.

* Footnote omitted.

repay dollar debts contracted by them before June 30, 1965, and it refrained from issuing exchange certificates to them in that amount.[11]

A Colombian subsidiary of a U.S. company that sold goods other than coffee or petroleum for export for $1,000 in 1967 and sold its exchange certificates at December 31, 1967, would have received 18,120 pesos from its sale, of which 15,760 pesos would have come from selling exchange certificates and 2,360 pesos (15% of 15,760 pesos) would have been received in the form of a tax credit. A Colombian subsidiary that purchased goods for import for $1,000 and obtained its exchange certificates at December 31, 1967, would have paid 15,820 pesos for its purchase.

Translation Procedure. Import purchases or export sales under multiple exchange rate systems are accompanied by transfers of both foreign money and dollars. The assets and liabilities that pertain to the export or import sales should be measured in the foreign money financial statements in terms of the foreign money transferred, and they should be measured in the translated financial statements in terms of the dollars transferred. The account receivable (including the amount due for the tax credit) and revenue that pertain to the export sale in the preceding illustration should be measured at 18,120 pesos in the foreign money financial statements and at $1,000 in the translated financial statements. The asset and account payable that pertain to the import purchase in the preceding illustration should be measured at 15,820 pesos in the foreign money statements and at $1,000 in the translated statements.

Assets and liabilities that pertain to import purchases and export sales under multiple exchange rate systems can be measured in terms of the dollars transferred by translating the amounts reported for them in the foreign money financial statements at the import or export rate. In the preceding illustrations, the amounts reported in pesos for the export sale should be translated at $\$.05518\left(\frac{1}{18.12}\right)$, and the amounts reported in pesos for the import purchase should be translated at $\$.06321\left(\frac{1}{15.82}\right)$.

An argument might be made that import and export transactions under multiple rate systems with parties other than the U.S. parent company or another subsidiary are not in substance accompanied by a transfer of dollars from the viewpoint of the U.S. company. The U.S. company through its foreign subsidiary immediately exchanges dollars

[11] *Nineteenth Annual Report on Exchange Restrictions,* p. 99.

for foreign money after receiving them from the purchaser, and it immediately pays dollars to the seller after obtaining them in exchange for foreign money. Since the U.S. company only momentarily owns the dollars it receives or pays, the import or export transaction might be treated in the translated statements as a purchase or sale accompanied solely by a transfer of foreign money. The amounts reported in the foreign money financial statements for the import or export transaction might therefore be translated at the dividend rate just as other sales and purchases accompanied solely by a transfer of foreign money are translated.

Translating import and export transactions under multiple rate systems at the dividend rate is undesirable, however, because it introduces inconsistent measurements into the consolidated financial statements. A U.S. company that buys or sells goods for dollars through the parent company or a domestic subsidiary would measure the transaction in a different way than if it buys or sells goods for dollars through a foreign subsidiary in a country with a multiple rate system. A purchase or sale of the same kind of goods at the same price would consequently be reported at significantly different dollar amounts. The revenue from the export sale in the preceding illustration would be reported at \$1,112 $\left(18{,}120 \times \frac{1}{16.30}\right)$, but revenue from a sale of the same kind of goods at the same price by the parent company or another subsidiary would be reported at \$1,000. The imported goods in the preceding illustration would be reported at \$971 $\left(15{,}820 \times \frac{1}{16.30}\right)$, but the same kind of goods purchased at the same price by the parent company or another subsidiary would be reported at \$1,000. A U.S. company could report the export or import transaction at different amounts by arranging alternatively for the subsidiary or the parent company to make collection or payment. These results should be avoided by translating import and export transactions under multiple exchange rate systems at the import or export rate instead of the dividend rate.

Gains and Losses on Exchange at Import or Export Rates. A U.S. company gains or loses command over dollars when its foreign subsidiary exchanges foreign money or dollars at the import or export rate at the time of payment or collection. In the export sale illustration, the U.S. company decreased its money by the \$1,000 previously received from the vendee and increased it by 18,120 pesos worth \$1,112 if exchanged at the dividend rate—a net increase of \$112. In the import purchase illustration, the U.S. company increased its money

by $1,000 to pay the vendor and decreased it by 15,820 pesos worth $971 if exchanged at the dividend rate—a net increase of $29. The U.S. company should therefore report a gain of $112 in the period it exchanges dollars at the export rate, and it should report a gain of $29 in the period it exchanges pesos at the import rate. The U.S. company would report losses instead of gains if the export rate were higher and the import rate lower than the dividend rate in terms of dollars.

Gains and losses on exchange at import and export rates appear as a component of foreign exchange gains and losses in the translated financial statements. Both kinds of gains and losses occur on monetary items and neither can be measured in terms of foreign money. Gains and losses on exchange at import and export rates should be reported separately because they cannot be controlled by the procedures used to control foreign exchange gains and losses.

George Watt recommended a procedure for reporting import purchases subject to import rates under which the difference between the import rate and the dividend rate (described by him as a "subsidy" or "penalty") is credited or debited to the cost of the imported asset.[12] Under that procedure, the liability to the supplier is translated at the import rate, and the cost of the imported asset is translated at the dividend rate; the difference between the two amounts is reported as a deferred charge or deferred credit in the translated balance sheet. The deferred charge or credit is omitted in the translated balance sheet for the end of the period in which foreign money is exchanged at the import rate, and no gain or loss on exchange at the import rate is consequently reported in this period because omission of the deferred amount gives rise to an offsetting loss or gain. In the preceding import purchase illustration, the account payable would be reported at $1,000 and the imported asset at $971, and the difference of $29 would be reported as a deferred charge. A gain of $29 on exchange at the import rate would not be reported in the period of the exchange because the deferred charge of $29 would be omitted from the translated balance sheet for the end of this period. The "subsidy" of $29 is consequently credited to the cost of the imported asset.

Watt would credit or debit the "subsidy" or "penalty" to the cost of the imported asset to avoid reporting it as a gain or loss in periods before the asset is sold or used up. He gave a reason for crediting "subsidies" to the cost of imported equipment:

> Profit is not made by purchasing equipment. Actually the foreign government is offering a subsidy (preference) to encourage

[12] *Handbook of Modern Accounting*, 1970, Chapter 33, pp. 24-27.

> the importation of the item. Therefore, the accountant should not be reluctant to translate the local currency used to acquire a tractor at $8,000 in the property accounts even when $10,000 was paid to the U.S. manufacturer.[13]

Crediting the gain (or "subsidy" as Watt calls it) to the cost of the asset by using a deferred charge is undesirable, however, because an anomalous amount is introduced into the balance sheet as an asset that does not represent an economic resource. The gain occurs because the foreign government allows the U.S. company to exchange money of the country at a higher rate than the rate previously applicable to the money exchanged. If the gain is to be credited to the asset before foreign money is exchanged at the import rate, it should be reported in the balance sheet by translating at the import rate cash and receivables that will be collected before exchange at the import rate occurs in an amount equal to the amount of foreign money to be exchanged at the import rate. Cash and receivables should be translated at only the dividend rate in the balance sheet for the end of the period in which foreign money is exchanged at the import rate to avoid recognizing the gain on exchange in this period.

Accountants who believe that "earnings arise from the use of facilities, not from their acquisition"[14] might agree that the gain or loss on exchange at the import rate should be credited or debited to the cost of the imported asset to avoid reporting it before the asset is sold or used up. But the relevance to readers of financial statements of this restriction on reporting earnings has never been demonstrated. Reporting the gain or loss in the period the exchange occurs provides a better measure of net income, and the procedure is simpler to apply.

[13] *Ibid.*, p. 27.

[14] AICPA, *Accounting Principles Board Opinion No. 2*, "Accounting for the 'Investment Credit'," December 1962, par. 12.

7

Disclosure

Separate disclosure of financial statement amounts that pertain to consolidated foreign subsidiaries has been encouraged by pronouncements of the American Institute of Certified Public Accountants. In December 1939, the committee on accounting procedure recommended that if foreign subsidiaries are consolidated, U.S. companies should present "a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company's equity therein," or alternatively should present supplemental "consolidated statements for domestic companies only."[1] The supplemental statements would enable readers to determine the financial statement amounts in the primary statements that pertain to consolidated foreign subsidiaries. The same disclosure recommendation was carried forward in Chapter 12, "Foreign Operations and Foreign Exchange," of *ARB 43* in 1953.[2]

In the more than 30 years since this disclosure recommendation was originally formulated, investments of U.S. companies in foreign countries increased, and political and economic conditions in foreign countries changed. Many U.S. companies now disclose more information than recommended in *ARB 43*. Disclosure of financial information that

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[1] AICPA, *Accounting Research Bulletin No. 4 (Special)*, "Foreign Operations and Foreign Exchange," pars. 6(a), 6(c). The committee also recommended that U.S. companies disclose similar financial statement information pertaining to unconsolidated foreign subsidiaries. Unconsolidated foreign subsidiaries are not discussed in this chapter, however, because the more general disclosure recommendation in par. 21 of *Accounting Research Bulletin No. 51*, "Consolidated Financial Statements," requires U.S. companies to present summaries of the financial statements of both domestic and foreign unconsolidated subsidiaries.

[2] AICPA, *Accounting Research Bulletin No. 43*, "Restatement and Revision of Accounting Research Bulletins," par. 9.

pertains to consolidated foreign operations should therefore be re-examined.

General Purpose of Disclosure

The committee on accounting procedure indicated the general purpose of disclosing financial information about foreign operations in Chapter 12 of *ARB 43:*

> 2. Since World War I foreign operations have been influenced to a marked degree by wars, departures from the gold standard, devaluations of currencies, currency restrictions, government regulations, etc.
>
> 3. Although comparatively few countries in recent years have had unrestricted currencies and exchanges, it is nevertheless true that many companies have been doing business in foreign countries having varying degrees of restrictions; in some cases they have been carrying on all operations regarded as normal, including the transmission of funds. In view of the difficulties mentioned above, however, the accounting treatment of assets, liabilities, losses, and gains involved in the conduct of foreign business and to be included or reflected in the financial statements of United States companies requires careful consideration.
>
> 4. A sound procedure for United States companies to follow is to show earnings from foreign operations in their own accounts only to the extent that funds have been received in the United States or unrestricted funds are available for transmission thereto. Appropriate provision should be made also for known losses.
>
> 5. Any foreign earnings reported beyond the amounts received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant, and they should be reserved against to the extent that their realization in dollars appears to be doubtful.
>
> 6. As to assets held abroad, the accounting should take into consideration the fact that most foreign assets stand in some degree of jeopardy, so far as ultimate realization by United States owners is concerned. Under these conditions it is important that especial care be taken in each case to make full disclosure in the financial statements of United States companies of the extent to which they include significant foreign items.

The unfavorable operating conditions in foreign countries, described in those paragraphs, convinced the committee in 1953 that companies should continue the disclosure of financial information about foreign operations originally recommended in 1939. The disclosure was intended to help readers assess the risks involved.

The committee's view of foreign operations is understandable. *ARB 43* was issued in 1953 when the experiences of U.S. companies in foreign countries during the great depression and World War II and its aftermath were still bitter memories. Favorable aspects of foreign operations were still so overshadowed by unfavorable ones that they were probably not considered in deciding whether to continue the disclosure recommendation.

The dramatic increase in direct overseas investment by U.S. companies cited in Chapter 1, however, is evidence that the investment opportunities, business environment, and operating conditions in foreign countries have greatly improved. Favorable conditions of foreign operations of U.S. companies today probably outweigh unfavorable conditions, if one considers the total foreign operations of all U.S. companies. Disclosure today should therefore serve a broader purpose than that specified in *ARB 43*.

The economic, political, and cultural characteristics of a country significantly shape its business environment, and business environments vary from country to country because of differences in these characteristics. Therefore, a U.S. company in a foreign country operates in a business environment different from that in the United States. Special restraints on foreign-owned businesses in many countries also contribute to the difference. The need to disclose financial information about foreign operations now arises more from the difference in the business environments than from unfavorable or favorable aspects of foreign operations generally. The purpose of disclosure should be to inform readers of the extent to which U.S. companies operate in different business environments where their operations may be subject to different degrees of risk, rates of profitability, and possibilities for growth.

Transacting business in foreign countries with moneys other than the U.S. dollar may be considered a sufficient reason for disclosure. Money differences are only one of many differences, however, between the business environments in foreign countries and that in the United States. Differences in business environment would probably be great enough for disclosure even if all countries used the same money. Differences other than in moneys can be grouped into at least the following:

1. *Laws and government regulations.* U.S. companies operate in foreign countries under laws and forms of government regulation different from those in the United States. They may also be subject to special laws and special forms

of government regulation that do not apply to locally-owned businesses.

2. *Customs.* Customs that affect business operating conditions—for example, hours of work—differ between the United States and foreign countries. Different customs also create differences in demand for various kinds of products.
3. *Industrial development.* Most foreign countries are less developed industrially than the United States to varying degrees. Differences in industrial development cause differences in the technology of production and in the demand for various kinds of products.
4. *Taxes.* U.S. companies that operate in foreign countries are subject to forms of taxes dissimilar from those in the United States. They may also be subject to special taxes that do not apply to locally owned businesses.
5. *Special risks.* U.S. companies that operate in foreign countries may be subject to risks of expropriation, confiscatory taxes, and official or semi-official harrassment.

If foreign countries differed in no major respects from the United States in their laws, customs, stage of industrial development, and so forth, the business environment throughout the world would be homogeneous, and there would be little reason to single out foreign operations for special disclosure of financial information. Some U.S. companies consider the business environment in Canada to be so similar to that in the United States that they exclude the operations of Canadian subsidiaries from other foreign operations for disclosure purposes and in effect treat Canadian operations as part of domestic operations in their annual reports.

Disclosing Differences Among Foreign Operations

The same factors that make the business environment different for U.S. companies in foreign countries also make the business environment in one foreign country different from that in another. For example, one country may be more industrially developed than another, or it may have a different tax structure. Some U.S. companies whose annual reports were reviewed in connection with this study recognized the difference in business environment among foreign countries by

grouping the foreign countries in which subsidiaries were located and disclosing financial statement amounts for each group. A disclosure category sometimes consisted of a single country rather than a group of countries.

Groups of countries for which information is disclosed generally consist of geographically proximate countries. The pattern of grouping varies considerably from company to company. For example, Standard Oil Company (New Jersey) disclosed foreign operations by hemisphere in a note to its financial statements in its 1970 annual report, shown below. Kimberly-Clark Corporation disclosed foreign operations by continent in a note to its financial statements in its 1970 annual report, shown opposite.

Countries that are not geographically proximate are occasionally grouped together for disclosure purposes. Such countries share common characteristics that are either explicitly stated in the annual report or are implicit in the grouping scheme. For example, General Motors Corporation grouped countries of the sterling area in a note to its financial statements in its 1970 annual report, shown on pages 82 to 83. Richardson-Merrell Inc. used the classification scheme of the U.S.

Standard Oil Company (New Jersey)
1970 Annual Report

The approximate geographical distribution of the total assets employed at December 31, 1970, and of the income for the years ended December 31, 1970, and 1969 was as follows:

	United States	*Other Western Hemisphere*	*Eastern Hemisphere*	*Total*
Current assets	$2,874	$1,122	$2,532	$ 6,528
Property and equipment, less reserves	5,080	2,162	4,063	11,305
Investments and other assets	191	248	970	1,409
Total assets employed	$8,145	$3,532	$7,565	$19,242
Represented by				
Current liabilities	$1,074	$ 660	$2,506	$ 4,240
Long-term debt	990	183	1,270	2,443
Reserves, deferred credits, and minority	378	677	553	1,608
Shareholders' equity	5,703	2,012	3,236	10,951
Total	$8,145	$3,532	$7,565	$19,242
Income before extraordinary charges: 1970	$ 629	$ 383	$ 298	$ 1,310
1969	$ 647	$ 358	$ 238	$ 1,243

Kimberly-Clark Corporation
1970 Annual Report

As of December 31, 1970, and for the year then ended, a financial summary of consolidated foreign subsidiaries is as follows:

	(thousands of dollars)		
	Total Assets	Net Sales	Net Income After Minority Interests
Canada	$ 68,795	$ 59,397	$3,762
Europe	93,319	91,142	2,255
Latin America	55,579	42,692	1,785
Far East	13,028	8,891	(7)
Total	$230,721	$202,122	$7,795
% to total consolidated	24	23	20

government Foreign Direct Investment Control program in a note to its financial statements in its 1970 annual report, shown on page 84.

Companies that disclose financial statement amounts in total for all foreign subsidiaries comply with the disclosure recommendation of Chapter 12 of *ARB 43*. That disclosure was perhaps adequate when *ARB 43* was issued. Foreign operations of U.S. companies were not as extensive or diverse as they are now. The growth in foreign operations of U.S. companies since then has created an apparent need for more detailed disclosure. Many U.S. companies presently operate in countries with diverse business environments, and insufficient information is furnished for these companies if all foreign subsidiaries are combined for disclosure purposes. U.S. companies that operate in foreign countries with diverse business environments should disclose financial information that reflects the diversity. Diversity in business environment is generally sufficiently reflected by disclosing financial statement amounts for a group of foreign countries with generally similar environments. Disclosure of financial statement amounts for a single country may sometimes be necessary, for example, if a company operates in only two foreign countries with significantly different business environments or if a company operates in a country that has placed severe restrictions on operations in that country.

No single method of grouping can reflect all the differences among the business environments of the foreign countries in which a U.S. company operates. A method that reflects some differences is likely to ignore others. Grouping according to level of industrial development, for example, may result in placing countries with close political ties in different groups. A company should classify on the basis of

Net Assets Outside the United States and Canada

	December 31, 1970				
	Western Europe	United Kingdom, Australia, New Zealand and South Africa	Other, Principally Mexico and South America	Total	December 31, 1969 Total
Assets:					
Cash	$ 19,078,780	$ 10,596,767	$ 14,865,403	$ 44,540,950	$ 37,685,952
Foreign government securities and time deposits	13,761,700	14,599,200	3,937,900	32,298,800	192,673,086
Accounts and notes receivable	65,373,578	154,093,349	86,414,222	305,881,149	270,427,081
Inventories	341,684,400	410,314,900	143,554,755	895,554,055	763,826,525
Total current assets	439,898,458	589,604,216	248,772,280	1,278,274,954	1,264,612,644
Real estate, plants, and equipment	1,152,435,412	1,008,205,900	216,529,342	2,377,170,654	2,225,840,605
Less accumulated depreciation and obsolescence	670,031,088	598,248,600	109,514,425	1,377,794,113	1,250,813,682
Net real estate, plants, and equipment	482,404,324	409,957,300	107,014,917	999,376,541	975,026,923
Other assets	38,150,019	18,026,368	30,614,513	86,790,900	81,271,655
Total assets	960,452,801	1,017,587,884	386,401,710	2,364,442,395	2,320,911,222

Deduct:					
Bank borrowings and notes payable	72,660,500	212,619,500	63,491,700	348,771,700	266,499,800
Foreign income taxes	34,012,800	70,870,300	11,076,200	115,959,300	106,560,700
Other current liabilities	216,519,979	189,740,962	84,626,014	490,886,955	415,305,338
Total current liabilities	323,193,279	473,230,762	159,193,914	955,617,955	788,365,838
Foreign debt of subsidiaries	187,210,800	49,050,000	9,439,900	245,700,700	280,463,800
Other liabilities	83,256,272	50,364,035	22,746,547	156,366,854	170,051,434
Sundry reserves	9,356,066	8,966	7,550,100	16,915,132	12,546,247
Total deductions	603,016,417	572,653,763	198,930,461	1,374,600,641	1,251,427,319
Balance	$ 357,436,384	$ 444,934,121	$187,471,249	989,841,754	1,069,483,903
Less General Reserve Applicable to Foreign Operations				141,667,396	141,667,396
Net Assets Outside the United States and Canada				$ 848,174,358	$ 927,816,507

	Year 1970	Year 1969
Net Sales Outside the United States and Canada	$3,652,151,252	$3,378,452,594
Net Earnings From Sources Outside the United States and Canada	$ 118,165,071	$ 159,696,947

Richardson-Merrell Inc.
1970 Annual Report

In the following table, foreign assets (in thousands of dollars) are grouped in accord with the classifications established by the U.S. Government in the Foreign Direct Investment Control program. "A" represents the less developed countries, including Latin America, India and the Philippines; "B" represents countries where a high inflow of capital is essential and includes the United Kingdom, Australia and Japan; "C" represents the more fully developed countries and includes Western Europe and South Africa.

	Canada	Group A Countries	Group B Countries	Group C Countries	June 30, 1970	June 30, 1969*
Current assets	$5,210	$24,006	$17,122	$49,057	$95,395	$82,095
Current liabilities	(858)	(6,928)	(10,330)	(15,566)	(33,682)	(20,692)
Net current assets	4,352	17,078	6,792	33,491	61,713	61,403
Fixed and other assets	1,522	12,090	5,864	17,118	36,594	31,902
Non-current liabilities	—	(1,257)	(7,926)	(17,603)	(26,786)	(20,095)
Net assets	$5,874	$27,911	$ 4,730	$33,006	$71,521	$73,210

*Reclassified

differences that are most important in its particular circumstances. Since differences vary in importance from company to company, even companies that operate in the same foreign countries may need to adopt different bases of grouping to best reflect the diversity of the business environments in which they operate.

Geographical Summaries of Assets and Liabilities

To prepare a geographical summary of assets and liabilities, all assets and liabilities in the consolidated balance sheet have to be associated on some basis with individual countries or groups of countries, including the United States. *ARB 43* recommends that the association be made on the basis of the location of the company in whose accounting records the asset or liability is recorded. This method, which might be called an accounting records method, is not the only one used in practice. Some U.S. companies use what might be called a source of risk method under which the association does not primarily follow accounting records. Peter Kocan described a source of risk method of associating assets and liabilities with regions,[3] whereby property, plant, and equipment and inventories are assigned to the region in which they are located. Cash in banks, receivables, and marketable securities that represent claims to cash are assigned to the region in which the debtor is located because "the safety of such assets depends first on the policies of the country in which the debtor is located, not the country in which the creditor (i.e., the foreign branch or subsidiary company) is located."[4] Investments in equity securities are assigned to the region in which the investee operates. If the investee operates in more than one region, "it may be desirable to allocate the investment between regions if enough information is available."[5]

The source of risk method proposed by Kocan generally assigns liabilities to regions in the same way as under the accounting records method; that is, to the region of the company in whose accounting records they are recorded. Kocan would not, however, assign all liabilities in that way:

> For example, a subsidiary company operating in Country X borrows money from a bank located in Country Y, the loan being

[3] "Geographical Distribution of Earnings and Assets," *The Journal of Accountancy,* June 1963, pp. 52-53.

[4] *Ibid.,* p. 52.

[5] *Ibid.*

guaranteed by the parent company. If X should "nationalize" the properties of the subsidiary company, the parent company becomes liable to the bank, and if this is so, the loan should be assigned to the region of the parent—which is the U.S.A. If the bank is located in Country X, however, the loan should be assigned to the region in which X is located, regardless of the parent company guarantee. This is justified by the probability that U.S. courts would not entertain any claim by a creditor in Country X.[6]

The two kinds of geographical summaries serve different purposes. A geographical summary prepared under the accounting records method indicates the net assets of a U.S. company invested in operations in various regions and is primarily useful in calculating rates of return for each region. A geographical summary prepared under the source of risk method is primarily useful in assessing the risks to the U.S. company from operating in particular regions. A U.S. company should present a geographical summary of assets and liabilities using the method that in the opinion of its management provides readers of its financial statements with the most useful information.

86 Disclosing Profit Information

ARB 43 recommends that U.S. companies present a summary of the income and losses of consolidated foreign subsidiaries for the year. Companies generally comply with the recommendation by disclosing net income in total for foreign subsidiaries. Very few companies disclose net income by country or group of countries or disclose revenue and expense components of net income. A significant number of companies present only summaries of assets and liabilities and do not disclose any profit information.

A U.S. company should disclose the net income of foreign subsidiaries in total and by country or group of countries if it operates in countries with significantly different business environments. Since profit information is presumably more useful to financial statement readers if revenue and expense components are disclosed as well as net income,[7] U.S. companies that disclose net income for foreign subsidiaries should also disclose revenue and expense components. The amount of detail that should be disclosed depends on the significance of the foreign subsidiaries to the U.S. company.

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[6] Kocan, "Geographical Distribution of Earnings and Assets," p. 53.

[7] AICPA, *Accounting Principles Board Statement No. 4 (APB Statement 4)*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," October 1970, par. 198.

Problems in Disclosure of Net Income. Transfer prices and common costs present problems in disclosing separately the net income of foreign subsidiaries.

Transfer prices. The operations of foreign subsidiaries are often vertically integrated with operations of the U.S. parent company or domestic subsidiaries; that is, products of foreign operations are used as components of production in domestic operations, or vice versa. For example, a note to the financial statements in the 1970 annual report of Caterpillar Tractor Co. stated that the "product of manufacturing subsidiaries located outside the United States in most instances consists of components manufactured or purchased abroad which are assembled with components manufactured in the United States and sold to the subsidiaries at intercompany prices." Also, a note to the financial statements in the 1970 annual report of Ludlow Corporation stated that foreign subsidiaries were "primarily engaged in manufacturing products for sale to the parent company."

Revenue from the sale of products to parties outside the consolidated entity results from both foreign and domestic operations if the operations are vertically integrated. Revenue is allocated between foreign and domestic operations according to the prices established for transfers of product between them. Establishing transfer prices that allocate revenue meaningfully is difficult. David Solomons has argued that transfers of product between divisions of a company should be priced at cost to the division that produced them:

> . . . the best procedure seems to be to eliminate inter-divisional sales from reports to stockholders. This is really equivalent to saying that all materials or products transferred between divisions shall be transferred at cost, including a proportionate share of overhead. The result will be to leave each division to bear the cost of goods sold to outside customers, and it would report sales to outsiders and the costs thereof.
>
> As a consequence of this procedure, important divisions which work mainly or perhaps wholly for other divisions of the company —the Fisher Body Division of General Motors might be an example—would disappear from the financial report, except to the extent that they had sales to outside customers. All earnings would be attributed to the divisions which market the final products. The result would be the same as if all stages of making the final product were carried on in the end-product division. For the purposes of financial reporting to stockholders, this is not at all an unsatisfactory result, whatever may be thought about it from a managerial point of view. It brings together in one place

> the profit which the company has extracted from a particular market—the market for Chevrolets, for instance, or all passenger cars, depending on how closely the financial statements follow the organization chart—without regard to the way the company has chosen to organize the manufacturing facilities used to serve this market.[8]

Pricing transfers of product at cost may be appropriate for the purpose of measuring profits on the different kinds of *products* sold by a company (Chevrolets, Oldsmobiles, etc.), but it is not appropriate for measuring profit on the different kinds of *operations* performed by a company (body manufacture, assembly, etc.). If the products of foreign subsidiaries are used entirely in domestic production and transfers of product are priced at cost, a company would report a net income of zero for foreign operations—in effect ignoring the contribution of foreign operations. Pricing transfers of product at cost allocates revenue among operations by arbitrarily assigning all revenue to the final operation, an allocation that is no more meaningful than that attained by pricing transfers at cost plus an arbitrarily selected markup.

Pricing transfers of product between vertically integrated operations at open market prices for the same kind of product might achieve a meaningful allocation of revenue between the operations. Open market prices, however, may not be widely available for this purpose. Of 678 companies that replied to a question on the subject, only 53 companies priced transfers of product in their accounting records at open market prices.[9] Mautz commented:

> . . . there are a great number of intra-company transfers for which no readily available open market transaction exists as a standard against which to measure the price used. Companies are organized differently and therefore will transfer partially finished products between components at different times and under different conditions. Their organizational structure unavoidably reflects a number of factors including historical development, facilities available, and operating practices, so there can be no assurance that internal transfers match open market transactions in such essential characteristics as degree of completion or state of processing. Thus, for a great many transfers, there may be no equivalent independent market price.[10]

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[8] "Accounting Problems and Some Proposed Solutions," in *Public Reporting by Conglomerates—The Issues, the Problems, and Some Possible Solutions*, edited by Alfred Rappaport, Peter A. Firmin, and Stephen A. Zeff (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1968), p. 100.

[9] R. K. Mautz, *Financial Reporting by Diversified Companies* (New York: Financial Executives Research Foundation, 1968), p. 36.

[10] *Ibid.*, p. 37.

Since open market prices are apparently not widely available for pricing transfers of product, U.S. companies may justifiably omit disclosure of net income of foreign subsidiaries if they must rely substantially on transfer prices to measure net income. If companies nevertheless disclose net income of foreign subsidiaries in those circumstances, they should disclose the portion of total sales or purchases that represent transfers of product and the method of pricing transfers. Determining what constitutes "relying substantially" on transfer prices is a matter of judgment. Over 80% of the financial analysts that replied to a question on the subject, for example, believed that net income amounts reported for an organizational unit "lose significance" if more than 20% of its total sales or purchases consist of transactions with other units of the same company.[11]

Transfers of product may represent a substantial portion of the sales or purchases of foreign subsidiaries in individual countries or groups of countries, but not represent a substantial portion of the total sales or purchases of foreign subsidiaries. The portions will differ if operations of a minority of foreign subsidiaries are vertically integrated with domestic operations or if operations of foreign subsidiaries are vertically integrated with each other but not with domestic operations. A U.S. company may therefore have to rely substantially on transfer prices to measure net income of foreign subsidiaries in individual countries or groups of countries even though it does not have to do so to measure the total net income of foreign subsidiaries. Under those circumstances a company may justifiably omit the disclosure of net income for individual countries or groups of countries even if balance sheet information is presented on that basis. If net income for individual countries or groups of countries is nevertheless disclosed in those circumstances, the company should disclose the portion of total sales or purchases for each country or group of countries that represents transfers of product and the method of pricing transfers.

Common costs. The problem of allocating common costs is the same as the problem of allocating common revenue: costs must be allocated on the basis of formulas that are essentially arbitrary. Practically all U.S. companies with foreign operations incur costs that benefit both foreign and domestic operations—for example, the costs of operating the top administrative offices. Other costs may also benefit both foreign and domestic operations—for example, institutional advertising, product development, and executive bonuses or other executive compensation.

[11] *Ibid.*, p. 309.

Some accountants that recognize the difficulty of allocating common costs nevertheless advocate allocation. For example:

> Allocation of this period's costs that are joint or common to several divisions to specific individual divisions is an enormously difficult, virtually intractable problem. In fact, it is almost as difficult and intractable as the problem of allocation of depreciation to specific individual years. I suggest that the cost of all durable equipment is joint to the several accounting periods that benefit from the use of the equipment, and there is no conceptually satisfactory, generally accepted way to allocate it to individual periods. All joint cost allocations are arbitrary; none can be said to follow logically the economic facts. Yet we've been calculating depreciation in a more or less acceptable fashion for a long time. Our present income statement contains a goodly number of joint cost allocations. Will one more matter?
>
> I am reminded of the most apt comment of George O. May that the reporting of business income for short-time periods would be indefensible if it were not indispensable. The same may well be said of divisional income reporting.[12]

This argument maintains that allocating common divisional costs is just as arbitrary as allocating common period costs. That both kinds of allocations are equally arbitrary does not mean, however, that both are equally acceptable. Net income for periods reflects period allocations but not divisional allocations whereas net income for divisions reflects both kinds of allocations. Net income for divisions is therefore more arbitrarily determined than net income for periods. Many users of financial statements believe that divisional net income attains a degree of arbitrariness that seriously impairs its usefulness. Over 80% of the financial analysts who replied to a question on the subject, for example, believed that net income amounts for a division "lose significance" if allocated common divisional costs comprise more than 20% of the division's revenue.[13]

The arguments against allocating common divisional costs appear at least as strong as the arguments for allocating them. U.S. companies may therefore justifiably omit the disclosure of net income of foreign subsidiaries in total or for individual countries or groups of countries if a substantial amount of costs common to both foreign and domestic

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[12] Sidney Davidson, "Implications of Conglomerate Reporting for the Independent CPA—Comments," in *Public Reporting by Conglomerates—The Issues, the Problems, and Some Possible Solutions,* edited by Alfred Rappaport, Peter A. Firmin, and Stephen A. Zeff (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1968), p. 88.

[13] Mautz, *Diversified Companies,* p. 309.

operations must be allocated to measure net income. If companies nevertheless disclose net income that reflects allocation of a substantial amount of common costs, they should also disclose the total amount of costs common to foreign and domestic operations and the portion allocated to foreign subsidiaries in total or to each country or group of countries.

Disclosure of Contribution Margin. The contribution margin of foreign subsidiaries can be measured without allocating costs that are common to foreign and domestic operations. A contribution margin "is the addition to aggregate enterprise profit which is ascribable to the presence of a given segment in contrast to the aggregate profit which would have resulted in the absence of the segment."[14] In calculating a contribution margin for a segment, the only revenue and costs that are included in the calculation are

> the revenues and costs for which that segment is solely responsible. These are, in other words, the separable revenues and costs. A practical test is that the separable costs would not be present in the absence of the segment in question with all other conditions remaining the same. A long-run point of view needs to be taken in applying this test. That is, the situation should be viewed as it would be after all plant and equipment used in the specific segment's operations have been disposed of or transferred to other uses. Costs of facilities such as central headquarters shared jointly with other segments need not be allocated unless items of material size in these costs will be affected by changing fortunes of the individual segment.[15]

Disclosure of the contribution margin of foreign subsidiaries in total or for individual countries or groups of countries would apparently be useful to readers of financial statements. Approximately 88% of the financial analysts that replied to a question on the subject, for example, believed that disclosure of contribution margins of divisions of a company would be useful in their evaluations.[16] U.S. companies that omit disclosure of net income of foreign subsidiaries in total or for individual countries or groups of countries because measurement of net income requires allocating a substantial amount of common costs should therefore disclose contribution margins instead. Disclosure may be justifiably omitted if a company must rely substantially on transfer

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[14] Morton Backer and Walter B. McFarland, *External Reporting for Segments of a Business* (New York: NAA, 1968), p. 29.

[15] *Ibid.*, pp. 29-30.

[16] Mautz, *Diversified Companies,* p. 310.

prices to measure contribution margins. Revenue and expense components of contribution margins should also be disclosed.

Sales to Foreign Customers

Financial statement readers, particularly financial analysts, are apparently interested in having the sales of U.S. companies classified into "product" or "market" categories. Backer and McFarland interviewed a large number of financial analysts and reported that:

> Analysts would like to see sales data reported not only for product groups, but also by major markets, foreign versus domestic, and government (particularly defense) versus private customers. All of these are useful in terms of the analysts' income forecasting function.[17]

Sales to foreign customers that are further classified into categories of countries or groups of countries enable the analyst "to assess the growth potential and risk involved in particular countries or world areas."[18]

Disclosing sales of foreign subsidiaries in total or by individual countries or groups of countries provides no assurance, for several reasons, that readers of financial statements will receive the information on sales to foreign customers that they desire. First, U.S. companies that have no foreign subsidiaries may sell goods to foreign customers. Second, U.S. companies that have foreign subsidiaries may sell goods to foreign customers through the U.S. parent company or domestic subsidiaries. Third, foreign subsidiaries located in one country or group of countries may sell goods to customers located in another foreign country or group. Fourth, foreign subsidiaries may sell goods to customers in the United States.

U.S. companies are increasingly presenting summaries of sales to U.S. and foreign customers in their annual reports apart from income statement information that they may present for consolidated foreign subsidiaries. The summaries are generally presented outside the financial statement section and are not covered by the opinion of independent accountants.

Some companies reconcile the sales to foreign customers with the sales of foreign subsidiaries. For example, Eastman Kodak Company in its 1969 annual report presented the sales summary shown opposite.

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[17] Backer and McFarland, *External Reporting for Segments of a Business*, p. 47.

[18] *Ibid.*, p. 55.

Eastman Kodak Company
1969 Annual Report

Sales to:	1969 *(in millions)*	Change from 1968
Trade customers in the U.S.	$1,655.5	+ 5%
U.S. Government and defense contractors	248.4	−18%
Customers outside the U.S.	843.3	+10%
Total	$2,747.2	+ 4%

The company reported that sales to foreign customers exceeded the sales of foreign subsidiaries by $55 million because "sales to customers outside the U.S. include both sales by Kodak's associate companies abroad and exports by the U.S. companies directly to trade customers overseas." Borg-Warner Corporation also reconciled sales to foreign customers with sales of foreign subsidiaries in the sales summary presented in its 1969 annual report, shown on page 94.

U.S. companies, both those with foreign subsidiaries and those with no foreign subsidiaries, should disclose sales to U.S. customers and sales to foreign customers. Sales to foreign customers should be classified by country or groups of countries if foreign customers are located in countries with significantly different potentials for growth in sales or risks of loss of markets. Since a given foreign country may represent a different potential for growth in sales or risk of loss of market to one U.S. company than to another, different U.S. companies that sell to customers in the same foreign countries may need to adopt different classification schemes for foreign sales to fit their particular circumstances.

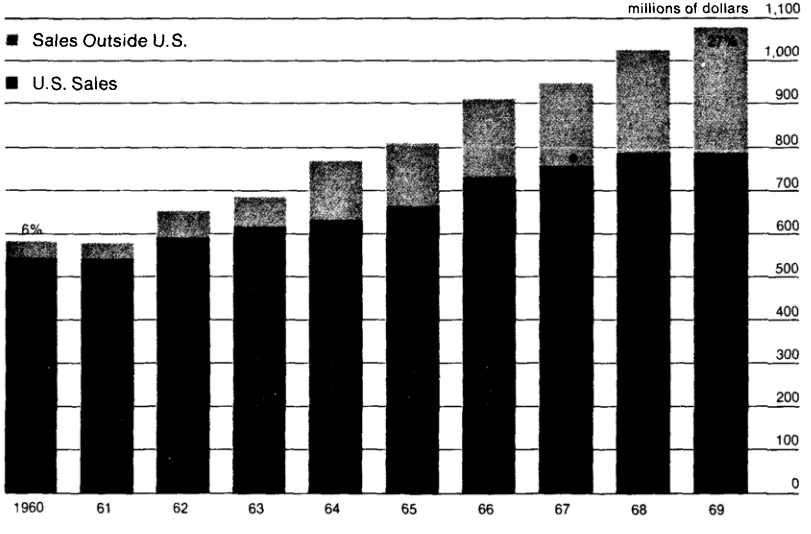
Summary of Disclosure Recommendations

U.S. companies may not disclose enough financial information about their foreign operations when they comply with the disclosure recommendations of Chapter 12 of *ARB 43*. The following disclosure recommendations for U.S. companies are developed in this chapter:

1. Financial information that pertains to foreign operations should be disclosed by country or group of countries if a company operates in countries with significantly different business environments.

2. A summary of assets and liabilities that pertain to for-

Borg-Warner Corporation
1969 *Annual* Report



Emergence of a world corporation

In the 1960 decade Borg-Warner evolved into a world corporation, having major product groups with global responsibility and a steady growth of sales outside the United States. The chart shows that sales of Borg-Warner goods and services to non-U. S. customers has grown from $35 million in 1960, 6 per cent of the corporate total, to $298 million in 1969, more than 27 per cent. Of this amount about $200 million was produced abroad, the rest exported from U. S. plants.

eign operations should be presented under either the "accounting records" or "source of risk" method in total for all foreign countries or by country or group of countries.

3. Net income of foreign subsidiaries should be disclosed in total or by country or group of countries. Disclosure of net income may justifiably be omitted if net income must be measured by relying substantially on transfer prices or by allocating a substantial amount of common costs. The revenue and expense components of net income should also be disclosed. The portions of the sales or purchases of foreign subsidiaries that consist of transfers of product and the method of pricing transfers should be disclosed if net income is measured by relying substantially on transfer prices. The total amount of common costs and the portion allocated to foreign subsidiaries in total or to each country or group of countries should be disclosed if net income is measured by allocating a substantial amount of common costs.

4. If net income of foreign subsidiaries is not disclosed because of the problem of allocating common costs, their contribution margins should be disclosed in total or by country or group of countries. Disclosure of contribution margins may justifiably be omitted if contribution margins must be measured by relying substantially on transfer prices. The revenue and expense components of contribution margins should also be disclosed. The portions of the sales or purchases of foreign subsidiaries that consist of transfers of product and the method of pricing transfers should be disclosed if contribution margins are measured by relying substantially on transfer prices.

5. Sales to U.S. and foreign customers should be disclosed in total and by country or groups of countries if different growth potentials for sales or risks of loss of markets are experienced among countries.

Comments by Member of Project Advisory Committee

George C. Watt

Application of Judgment

Basic concept. I have subscribed to the monetary (current rate) and nonmonetary (historical rate) line by line approach since it was

advanced by Hepworth. Therefore, I have no objection to the temporal principle described in the study because, for all practical purposes, as the study indicates, it leads to the same result.

APB Statement No. 3, "Financial Statements Restated for General Price-Level Changes," uses the monetary-nonmonetary nomenclature, and I prefer that "terms" for these somewhat similar applications remain consistent for foreign exchange dialogue rather than changing to past and present "money prices."

Also, I would have preferred that the study would not have advocated the temporal principle for application without modification in *every* situation encountered. I believe that there are situations which merit modifying the results of any line by line translation approach—where business judgment senses that the line by line result must be unrealistic in the circumstances (paraphrased from *APB Statement No. 4,* "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," paragraph 173). More flexibility is needed to deal with multinational problems. Some situations which require deviations from the "temporal principle" are described below.

Stable currencies change. When both the home currency and the currency where the subsidiary is domiciled are relatively stable, the

current rate seems appropriate to report immediately the effect of the change. When the British pound was devalued in relation to the U.S. dollar by 14% in 1967, it was the first change since 1949. The situation relative to this reasonably stable currency called for U.S. parents to apply the new current rate to all U.K. subsidiary accounts and recognize the loss, or be prepared to justify translating fixed assets at the old, historical, "past" rate by forecasting continued profits expressed in U.S. dollars, in the face of little likelihood of increased pound unit sales prices in the local trade (except by relatively slow internal inflation) to cover the "heavy" depreciation to be expressed in dollars by application of the historical rate. If there is doubt that one or both of the currencies is stable, the current rate is not clearly appropriate and it may be better judgment to apply the procedures described in the next paragraph.

Constant movement in one direction. Where the foreign exchange rate moves frequently and in one direction in relation to the parent's home currency, the temporal principle will often be an appropriate starting point. Situations 1 and 3 in the table on page 98 call for judgment to determine whether deviations (deferrals) from the results of the line by line application of the temporal principle would not be more appropriate. While my views are fairly summarized in narrative form in Chapter 5, I have prepared the situation/decision table, shown on page 98, and added explanations for my suggested modifications of the temporal principle to illustrate the areas of my concern.

In Situation 1, where the foreign currency weakens, deferring the gain to the extent required to offset unrecognized potential loss on fixed assets tends to counteract the unconservative but traditional practice of maintaining the translation of fixed assets at historical foreign exchange rates rather than writing them down to the current rate—a gamble on the recuperative power of the fixed assets to produce a product which will sell for an increased local currency selling price sufficient to cover the replacement of fixed assets. Further, if gain is not deferred in this situation, local currency retained earnings at the new weaker rate at the moment of change could not produce the translated U.S. dollar retained earnings.

In Situation 3, where the foreign currency strengthens, deferral of a loss to the extent that there is a potential gain on fixed assets may be justified if the selling prices in local currency to both foreign and local trade can be maintained and any raw material from sources outside the local country will not increase the cost in local currency.

Situation/Decision Table

Situations	*Possible Modification of Temporal Principle*
Foreign subsidiary's currency *weakens* in relation to home country currency (loss potential is high):	
1. Subsidiary has an excess of monetary liabilities over monetary assets	Defer gain as an offset to unrecognized potential loss on fixed assets
2. Subsidiary has an excess of monetary assets over monetary liabilities	Write off loss to earnings—unmodified temporal principle
Foreign subsidiary's currency *strengthens* in relation to home country currency (potential gain situation):	
3. Subsidiary has an excess of monetary liabilities over monetary assets	Defer loss as an offset to unrecognized potential gain on fixed assets (cover concept)
4. Subsidiary has an excess of monetary assets over monetary liabilities	Recognize the gain as earnings —unmodified temporal principle

The "cover concept" (deferrals) is a pragmatic approach where, for a subsidiary in a net monetary liability position:

(a) when a foreign currency weakens, there can be little certainty of a "gain" dependent solely on the recuperative powers of nonmonetary assets, or

(b) when a foreign currency strengthens, considering the "cover" provided by nonmonetary assets, there is reasonable expectation of future "gains" from translation of amortization of such assets.

Fluctuating exchange rates. The current (current rate) and noncurrent (historical rate) approach was advocated by various committees of the AICPA from 1931 to 1939 during a time when foreign currencies moved *up* and down in relation to the U.S. dollar. During some of these years, the Brazilian cruzeiro strengthened. The word fluctuation was frequently used to describe movements and it meant just that. In these circumstances, translation of long-term items at historical rates made sense to those who saw movement in both direc-

tions. It is difficult today to rule out this approach in translating affiliations between United States and Canadian entities for example, although to my mind the approach has a drawback in that a huge lump sum settlement of a local long-term debt may occur and give rise to a significant gain or loss arising from the translation process in a year when the U.S./Canadian dollar exchange rate remained unchanged, making the reported gain or loss difficult to explain in connection with the report for the year of settlement. On the other hand, if the rate fluctuates during the life of the debt and returns by date of settlement to near the rate at date of issuance, who is to fault the procedure which eliminated the reporting of both gains and losses that never came to pass?

Reporting Unperformed Forward Exchange Contracts

The study recommends recording the market price of a forward exchange contract as an asset. My own position on this subject is accurately quoted in the study: an unrealized gain on an incomplete hedging transaction should be taken into income only to the extent of any unrealized exchange loss resulting from translation of the accounts subsequent to a devaluation (revaluation). I think it is questionable whether the study's proposal, which could result in accrual of a potential gain on an executory contract, is permissible within the framework of generally accepted accounting principles, particularly as to the application of the conservatism convention and the realization principle: losses should be recognized immediately but recognition of gains should await realization.

Multiple Exchange Rates Require "Extra" Procedures

In dealing with multiple exchange rates the study rejects the use of deferrals designed to mesh the booking of a transaction in a different period than the period when settlement is undertaken. It is unthinkable to me that a treasurer of a foreign subsidiary could, under the study recommendations, swing consolidated profits between years simply by paying creditors earlier or later as desired by the parent.

Deferred Income Tax Credit Balances Are Similar to Payables

The study classifies a deferred income tax credit balance as "past" rate. Whether one believes that deferred income tax credit balances

are deferred credits (*APB Opinion No. 11*) or liabilities, surely the advocates of either recognize that a timing difference that does reverse will cause additional taxes to be paid in the *future*, just like the payment of a long-term debt that falls due in the future. The current rate is the appropriate one.

Only Source of Risk Approach to Geographical Spread of Financial Information Has Validity

I regret that the location of the subsidiary company's records was acknowledged by the study as a recognized "method" of determining the geographical source of income and location of risk. Only the source of risk method, which analyzes each item in the records, has validity, although it is very difficult to apply in some circumstances. Is it reasonable to classify as a risk in Europe an account receivable on the books of a wholly owned French subsidiary due from a Japanese customer and payable at a New York bank in U.S. dollars? Of course not.

Some Preferred Stocks Are Monetary

While the following situation is infrequently encountered, the impact is major when identified. The temporal principle discussion in Chapter 3 of the study calls for the translation of *all* preferred stock at the past rate. There are a number of preferred stocks that are callable at a fixed amount in local currency. Obviously these should be translated at the current rate. It may make quite a difference to the view of the common stockholder. The propriety of the current rate rather than the past rate in these circumstances seems obvious.

An Illustration of the Translation of a Complete Set of Foreign Financial Statements Over Several Years Would Have Been Helpful

In general I believe this study of translating foreign branches and subsidiaries of U.S. companies should have included an illustration of a balance sheet before and after a change in a foreign exchange rate and then presented a summarized profit and loss statement for years following the rate change until all nonmonetary assets at the date of the rate change had been amortized. Such illustrations are essential if the study recommendations are to be examined and compared with

various situations and other approaches. *APB Statement No. 3* included an appendix which was a complete, articulating set of financial statements together with supporting working balance sheets and income statements and explanatory comments based on recommendations in the study. Discussion of this foreign exchange study will be hampered by the lack of case material similar to that found in *APB Statement No. 3.*

* * * * *

I concur with the decision of the Director of Accounting Research to publish the study because I believe the subject matter should be considered promptly.

Comments by Director of Accounting Research

Purpose of Comments

I append these comments to "Reporting Foreign Operations of U.S. Companies in U.S. Dollars" because I think the study is likely to be criticized at the wrong levels and for the wrong reasons.

Mr. Lorensen presents an essentially deductive study. He begins with the nature of the accounting measurement process and the purpose and nature of translation. From that foundation he develops the temporal principle of translation. A principle derived in that way cannot be overthrown logically except by attacking the process that produced it—that is, by rebutting the premises, reasoning, arguments, and evidence.

Of course, we accountants do not usually criticize research results in the way I describe. Nor do we usually show much intellectual discipline in the way we try to solve accounting problems. Accountants and businessmen habitually tend to concentrate on judging the numbers that result from accounting methods with little concern for underlying theory. The accounting profession has a long tradition of acting *ad hoc*—that is, methods are prescribed for specific items in specific circumstances to obtain specific results in financial statements without regard to the methods' general applicability, their consistency with other methods or with accepted basic concepts, or their relation to various bases of measurement that are or might be used in financial accounting. And the trend to *ad hoc* solutions to accounting problems probably has accelerated as the business and investment world has increasingly exalted the end numbers, epitomized in earnings per share.

By pointing out the essential folly and danger of *ad hoc* solutions, I hope to encourage discussion of the concepts and principles that underlie methods proposed in the study and other possible accounting methods. In the process, I also hope to discourage criticism of

the study based primarily on appraisals of end results instead of on theoretical analysis—criticism that concentrates on judging the numbers produced by accounting methods proposed in the study and advocates improving the numbers by substituting *ad hoc* other methods that produce numbers that in the critic's judgment are "better." The implications of my comments extend beyond the subject of the study, and I will elaborate after I mention the study itself.

Valid Criticism

I note several items in Chapter 2—the chapter in which the temporal principle is derived—that illustrate the levels at which I believe the study can be criticized validly.

A Premise. The study contains this statement (page 18): "The attribute of foreign money of most interest from the perspective of the U.S. dollar financial statements is its command over U.S. dollars." That apparently innocuous sentence is a major support for the temporal principle but is not defended in the study by analysis or evidence of any kind. It is an assumption—a premise—about how those who read financial statements of U.S. companies stated in U.S. dollars see foreign operations of U.S. companies. Another assumption might lead to a different principle of translation.

An Argument and Some Evidence. The study has a brief discussion (pages 14 to 16) of valuing receivables and payables. It notes an apparent inconsistency between *APB Statement No. 4,* "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," on the one hand and *APB Statement No. 3,* "Financial Statements Restated for General Price-Level Changes," and *Statement on Auditing Procedure No. 47 (SAP 47),* "Subsequent Events," on the other, concludes that the situation is confused, and opts for the interpretation in *APB Statement 3* and *SAP 47.* That is, receivables and payables are measured "at money amounts that pertain to the balance sheet date instead of to the future date of receipt or payment" (p. 16).

I believe the evidence available supports *APB Statement 4* that in concept receivables and payables are stated at the present value of amounts expected to be received or paid. Net realizable value for receivables is virtually the only conceptual explanation in the accounting literature going back almost a hundred years. An allowance for bad debts or uncollectible receivables is almost invariably described

in terms of estimating the amounts to be collected. Explanations of payables in terms of amounts expected to be paid are, if anything, even more specific. A large body of literature that is reasonably clear is better evidence than some recent documents that confuse the issue, especially since *APB Statement 3* and *SAP 47* were both directed to other matters and whatever they say on valuation of receivables and payables is at best a by-product.

The temporal principle in the study can, of course, accommodate either interpretation.

Methodology. I expect the study to be criticized as being from an "ivory tower" or lacking "empirical support." Within limits those criticisms may be valid. However, I believe that criticizing the study for overemphasizing a priori reasoning or for lacking empirical support is most valid *after* criticizing the a priori work. Surely, a first rule of criticism is to criticize the method that was used before criticizing a work for a method that was not attempted.

Also, criticism that the study lacks empirical support should be tempered. Criticizing an author for not testing premises or conclusions is easy; actual testing is more difficult, and empirical research worthy of the name is often extremely difficult. Mr. Lorensen might have included additional examples showing application of recommended procedures or even a comprehensive illustration, but that is exposition, not empirical research. He might have applied the temporal principle to an actual company to see how the accounting numbers would differ from those produced by other translation methods, but I doubt that the exercise would show much that cannot be known a priori. The conclusions of the study might penetrate some firmly held views that are impervious to reasoning if the study included an empirical test showing that the temporal principle produces results that are more useful to various groups, but I know of no successful, or even promising, attempts to test translation principles empirically. I see little point in spending time on tests that require heroic assumptions. In short, I think that a critic should not merely vaguely assert that Mr. Lorensen should have done more empirical research; the critic should explain what should be done and how.

Rejecting Numbers Implies Rejecting Historical Cost

Applying the temporal principle results in about the same numbers as present practice under the monetary-nonmonetary method. Those

numbers have been harshly criticized in many circumstances. They are claimed to be less "meaningful," less "realistic," or—to use a current catch phrase—less "in conformity with economic reality" than numbers produced by certain *ad hoc* methods.

If the numbers produced by translating with the temporal principle are indeed faulty, the first step in remedying those faults is to find the cause of the faulty numbers. That is, the process that produces the numbers should be analyzed to isolate the cause. I have already suggested a way to begin to examine that process—namely, to analyze the premises, reasoning, arguments, and evidence in the study that led to the temporal principle. I now suggest that a vital characteristic of the temporal principle points to another likely source if the numbers are faulty.

The temporal principle is neutral in the sense that it does not change the nature of the numbers it translates—acquisition cost comes through translation as acquisition cost, replacement price comes through as replacement price, sales price comes through as sales price, and so forth. Objections to the numbers produced by the temporal principle are not therefore primarily criticisms of the translation process at all but of the numbers before translation. Thus, the criticisms are really of historical cost accounting, specifically of the fact that certain kinds of increases in net assets are recognized and others are not.

The *ad hoc* methods that are claimed to produce numbers that are better actually recognize, directly or indirectly, profits that are unrealized under historical cost accounting. They produce numbers that are not current costs or current values but are often closer to those values than are acquisition costs. The historical cost basis of accounting is changed *ad hoc*.

Disciplined Change vs. Ad Hoc Change

My immediate concern is not, however, with whether the present historical cost basis of accounting should be retained, changed, or replaced. Nor do I argue that change should be delayed until we can discover or develop a complete set of coordinated principles that constitute a theory that is entirely internally consistent and describes "accounting truth."

Rather, I emphasize that changing accounting methods *ad hoc* is a way of modifying financial accounting that is entirely different from changing concepts or principles within the context of the relatively stable frame of reference we often called theory. That is, the compo-

nents of theory—for example, the perceived relation between accounting numbers and the economic things and events they purport to measure, basic concepts that are described in *APB Statement 4,* or the conventions and rules that describe accounting measurement—usually change only slowly or at relatively long intervals and limit changes in accounting. *Ad hoc* changes have few, if any, restraints.

The issue is whether accountants should, in the name of improving financial accounting, adopt whatever methods seem to them to give better answers for particular items in particular circumstances or whether changes in accounting should generally be governed by—and perhaps inhibited by—theory. I believe the answer is clear: a relatively stable frame of reference is essential to orderly progress in financial accounting. The components of that frame of reference should be changed only directly and intentionally after careful thought and investigation of the implications rather than indirectly and perhaps unintentionally as a by-product of adopting a method to achieve a specific result.

The great risk of changing financial accounting *ad hoc,* with the attendant concentration on the numbers produced instead of on the underlying theory, is that the numbers produced by accounting will be divorced more and more from the economic things and events that they purport to measure. As accounting numbers increasingly incorporate devices that are merely inventions for accounting rather than representations of things and events in the real world, the numbers will increasingly be irrelevant and useless to those who rely on financial statements.

Ad Hoc Solutions

Translation of foreign financial statements into domestic money has recently been a fertile field for *ad hoc* methods—proposed shortcuts that emphasize "better" numbers and de-emphasize theory. Two of the most prominent recent proposals to improve translation are (1) to translate all foreign money amounts at the current foreign exchange rate, a proposal with eminent sponsorship among professional accounting bodies in other countries and among practitioners and professors in the United States, and (2) to defer "debit translation adjustments" (formerly called losses) that result from strengthening of foreign moneys relative to the U.S. dollar, a proposal that achieved some respectability late last year as a key conclusion of an exposure draft of an aborted APB Opinion. Mr. Lorensen disposes adequately in the study of several *ad hoc* proposals, including those two, but they

illustrate well the major characteristics and faults of most *ad hoc* methods.

Economic Unreality. Translating all foreign money amounts at the current foreign exchange rate is merely tinkering with the translation process and cannot possibly correct the faults that its proponents attribute to the numbers produced by historical cost accounting. The failure of the method is shown by translating at the current exchange rate any asset accounted for in foreign money at acquisition cost but shows most clearly in translating a long-term asset—for example, a machine—whose price has risen since acquisition.

Historical cost × *current rate.* Multiplying the historical cost of a machine—which may have been acquired one, five, ten, or more years ago—by a current exchange rate that differs from the rate at date of acquisition produces a number that is not historical cost in dollars. Further, except by coincidence, it is neither replacement price nor sales price in dollars. Nor is it any other measure of cost or value in dollars. The number is in fact nothing except the product of multiplying two unrelated numbers. Certainly it cannot be added to the dollar cost of domestic machines to obtain a number that may validly be called a total acquisition cost of machines in dollars.

Relative reality. Despite the kind of number produced by translating a historical cost at a current exchange rate, a major claim for the method, if not the major argument for it, is that the result is more meaningful, more realistic, or more in conformity with economic reality than translating historical cost at the foreign exchange rate at the date of acquisition. If we accept the definition of economic reality implicit in the claim—namely, replacement price, sales price, or some other measure of current cost or current value—the number produced by the method indeed often is *more* realistic or *more* in conformity with economic reality than the number obtained by translating historical cost at the historical rate. But so is every number between historical cost and the defined reality. And some are more realistic than the number produced by the current rate; that is, they are closer to the reality end of the range. Given a definition of reality, the aim of financial accounting should be to produce numbers that are close to reality, not numbers that are merely in the right direction from numbers obtained by translating historical cost at the historical rate.

The discipline of a basic concept. The nature of the things and events that financial accounting purports to measure should impose

limits and discipline on financial accounting. For example, *APB Statement 4* defines financial accounting as a process to provide quantitative representations of certain aspects of economic resources, of obligations to transfer economic resources, and of changes in resources and obligations. Usefulness of a representation lies in its corresponding to the thing or event represented. The kind of correspondence that makes financial accounting useful is not like that which an art lover might see in an abstract painting or a concertgoer might hear in a tone poem but a more concrete type comparable to that which a traveler sees in a road map that enables him to find his way.

An accounting representation that purports to be the acquisition cost of merchandise, for example, should be a measure of the value that was given up to acquire the merchandise, and an accounting representation that purports to be a replacement price of a machine should be a measure of the value that would now be given up to acquire the machine. Therefore, a number produced by accounting that is a reasonable approximation of the acquisition cost, replacement price, sales price, net realizable value, or other financial aspect of an economic resource may validly be described as a quantitative representation that corresponds to the thing or event represented. The same may be said of a number that reasonably approximates the present value, maturity value, or other financial aspect of an obligation to transfer economic resources and of numbers that reasonably approximate changes in financial aspects of economic resources and obligations to transfer resources.

Thus, several aspects of economic things and events can be represented quantitatively with reasonable correspondence. We can—and do—argue whether the particular financial aspect of an economic resource or obligation that is represented by an accounting number—acquisition cost, replacement price, sales price, net realizable value, maturity value, present value of expected cash receipts or payments, etc.—is the most useful aspect for the purpose intended. That question is in essence what discussions of needs of users of financial statements and of "objectives" is all about. Needs of users and objectives are also factors in determining which economic resources and obligations of an entity should be shown as assets and liabilities in its balance sheet and which changes should be shown as revenue and expenses in its income statement.

Meaning of economic reality. The concept that accounting numbers are quantitative representations of things and events in the real world gives operational meaning to economic reality: (1) the num-

bers must relate to things and events—for example, only items that can properly be described as economic resources and obligations of an entity can be represented quantitatively as its assets and liabilities and only changes that can properly be described as changes in economic resources and obligations of an entity can be represented quantitatively as its revenue and expenses—and (2) the numbers must reasonably approximate financial aspects of economic resources and obligations—for example, purchase price now or at the date acquired, sales price now or at some past or expected future date, expected cash receipt or payment, or maturity value.

The number produced by translating acquisition cost of a machine by a current rate is not a quantitative representation of anything in the real world and may not validly be described as economic reality. And if the expression "economic reality" and its derivatives—"realistic," "meaningful," etc.—are to have operational meaning in financial accounting, they must mean more than that the result is realistic in someone's judgment or that the number provided by an accounting method is in the general direction of the cost or value being measured.

Ignoring Our Own Rules. Deferring "debit translation adjustments" is an excellent example of an *ad hoc* method that ignores a rule that we profess vigorously to obey—it fails to recognize losses at the time they occur. A loss occurs at the date a foreign exchange rate changes because more dollars are required to pay the foreign debt than were required before the change in rate.

The discipline of some pervasive principles. Choosing historical cost as the financial aspect of economic resources to be represented quantitatively imposes limits on financial accounting. The essential characteristics of historical cost accounting are determined primarily by the principles (1) that assets and liabilities are recorded initially at prices established in exchanges with outside entities and (2) that revenue (a specific kind of increase in net assets) is recorded only when assets are sold after the revenue is mostly earned. The effect of those principles is modified occasionally by the broader notion of accrual to permit recognizing increases in assets without a sale and is modified often by the narrower notion of conservatism to require recognizing decreases in assets before sale.[1]

[1] *APB Statement 4*, pars. 144-154, 162-163, and 169-174. "Matching" is a corollary of Initial Recording (P-1) and Realization (P-2)—deferring costs to "match" them with revenue follows from deferring recognition of revenue until sale.

The result of those principles and their modifications is that assets are recorded above acquisition cost and revenue is recognized before sale only if the revenue is substantially earned, the amount of revenue is objectively known, and sale or delivery is more or less a formality. Otherwise, assets are invariably carried at acquisition cost or below—lower of cost and market or depreciated cost; losses are recognized before sale, but revenue never is. A distinguishing characteristic of the historical cost basis is that it defers recognizing increases in net assets and accelerates recognizing decreases.[2]

No economic loss. A common claim is that deferring "debit translation adjustments" is justified on grounds that no economic loss occurs on foreign debt if foreign money strengthens against the U.S. dollar because the U.S. dollar values of the long-term assets financed by foreign long-term debt increase concurrently. However, nonrecognition of losses or expenses because of "unrealized" increases in asset values is emphatically not part of historical cost accounting. Accountants in the United States have not seriously entertained that kind of argument since the early days of depreciation accounting.

Changing the basis. Since losses on foreign debt from changes in foreign exchange rates are exactly the kind of losses that must be recognized under presently accepted conventions, deferring those losses is impossible unless financial accounting is changed significantly.

However, talk of changing fundamentally or replacing the accepted historical cost basis of accounting has so far been just that—talk. Historical cost accounting has been criticized harshly, and the need to consider alternatives has been voiced repeatedly. Several possible alternatives have been suggested and described, and current value and current cost accounting have been much discussed, especially since *Accounting Research Studies Nos. 1* and *3* were published about ten years ago. Nevertheless, every proposal to change from historical cost is resisted fiercely, and the accounting profession has taken no significant step away from historical cost.

Rather, we invent methods that ignore the rules we profess to follow. No reason can be invented, however, to recognize "unrealized" gains on foreign assets by deferring losses on foreign debt without the same reasoning applying to domestic assets financed by domestic

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[2] Choosing another aspect of economic resources and obligations to be represented quantitatively might change the limits on financial accounting but would not remove them. For example, choosing the alternative of sales price or replacement cost would still limit recognizing revenue.

debt.[3] And the profession is apparently not ready to accept that accounting for domestic assets and liabilities.

Characteristics of Ad Hoc Methods

The two examples given illustrate the major distinguishing characteristics of *ad hoc* proposals: (1) a tendency to produce numbers unrelated to things and events in the real economic world, (2) supporting reasons that are mostly vague and abstract, and (3) little or no regard for the limits imposed by theory or even by conventions that accountants profess to follow.

Unrelated Numbers. Probably the most distressing recent examples of unrelated numbers produced by *ad hoc* solutions are the proliferation of items that Professor Sprouse has aptly named "what-you-may-call-its."[4] They are items included among the assets and liabilities that represent neither economic resources nor obligations to transfer economic resources. They are mere bookkeeping items that result from *ad hoc* methods. The definitions of assets and liabilities in Chapter 5 of *APB Statement 4* clearly reveal the gap that now exists between the real world that financial accounting purports to represent quantitatively (Chapter 3) and some of the accounting representations that result from current generally accepted accounting principles (Chapters 6, 7, and 8).

> *Assets*—economic resources of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Assets also include certain deferred charges that are not resources* but that are recognized and measured in conformity with generally accepted accounting principles.*
>
> *Liabilities*—economic obligations of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Liabilities also include certain deferred credits that are not obligations* but that are recognized and measured in conformity with generally accepted accounting principles.* [Underscoring added.]
>
> * Footnote omitted.

[3] I doubt that anyone is willing to argue that as a rule current costs or values of foreign plant and equipment are more objectively determinable than those of domestic assets. Under existing conventions, that argument is required to recognize an increase in foreign assets while retaining the historical cost of domestic assets.

[4] Robert Sprouse, "Accounting for What-You-May-Call-Its," *The Journal of Accountancy*, October 1966, pp. 45-53.

Vague and Abstract Support. *Ad hoc* proposals are almost invariably justified by claims that the methods advocated produce numbers that are better than those produced by other methods. Meaningful, reasonable, realistic, economic reality, and similar high-level abstractions are common in explaining *ad hoc* methods.[5] Bringing the arguments down from high levels of abstraction and demonstrating what the numbers really show usually reveals the true nature of the proposals.

Theory tends to follow rather than to precede *ad hoc* proposals and sometimes becomes imaginative. However, the explanations often change. For example, a whole series of theories have supported Lifo, one of the earliest and most successful *ad hoc* methods. The theories have ranged from arguments that Lifo allows management to hedge during long production processes for products having sales prices that vary with raw material costs to claims that it eliminates from net income many effects of changes in the general price level.

Yet at the beginning, theory for an *ad hoc* method tends to be a vague invoking of matching theory. How many methods have been defended on the abstract grounds that they produce "a better (or proper or appropriate) matching of costs with revenue"? Translated into plainer English, that means simply that the net income number produced by the method is better. Almost every "what-you-may-call-it" that is ever proposed is defended in the name of better matching.

Little or No Regard for Limits. "What-you-may-call-its" would not be introduced into financial accounting if we respected the limits of the basic accounting equation: Assets — Liabilities = Proprietorship (or $A = L + P$). But some accountants and businessmen feel repressed by those limits. They argue that accepting the limits of the equation is not only old-fashioned and unsophisticated but also prevents progress in financial accounting. Similarly, they blame much of our inability to solve many accounting problems on the so-called fetish of balancing—the requirement to relate the income statement and the balance sheet. They advocate relaxing or abandoning that requirement, seemingly on grounds that a superior net income number is produced by measuring revenue and expenses by themselves, that is, without the need to consider changes in assets and liabilities. But, descriptions of what income is if not specified kinds of net increases in net economic resources are noticeably lacking.

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[5] Unfortunately proposals that are not really *ad hoc* are often justified in the same vague terms, so vagueness is only a place to start and not an infallible way to identify *ad hoc* proposals.

Shortcuts with Shortcomings

Adopting accounting methods *ad hoc* is a shortcut that elevates judgment at the expense of analysis. Worse, it produces numbers that do not represent financial aspects of economic resources, obligations to transfer economic resources, or changes in resources and obligations. Instead, the numbers often represent merely bookkeeping items or other inventions of accountants.

Numbers like that are a great disservice to users of financial statements. However, *ad hoc* changes are also a great disservice to the accounting profession.

A Learned Profession Guided by Theory. Accountants aspire to be a learned profession. Among the evidences we give to indicate that we are worthy of that recognition is accounting theory—our somewhat loose designation for our body of specialized knowledge that supposedly guides accounting practice. Theory emphasizes fundamental relations and principles rather than the art of practice, is learned better in the classroom and the laboratory than through practical experience, and is advanced through research rather than through trial and error alone.[6] However, since we usually solve accounting problems *ad hoc*—emphasizing the circumstances of particular situations and de-emphasizing or ignoring underlying theory—our practical solutions shape the accounting theory rather than vice versa.

Consequences of *Ad Hoc* Change. Accounting theory has increasingly served not to develop practice that ought to be implemented but rather to rationalize practice after it has been adopted. One result, in my opinion, is that accounting theory has increasingly lost much of the internal consistency that it once possessed and accounting practice has increasingly become characterized by attempts to juxtapose irreconcilable methods, each supported by a so-called theoretical justification. Since almost anything can be called theory in that context, accounting theory is of little help in solving many accounting problems.

Another result, which is readily observable, is that financial accounting has declined in prestige at leading universities. Whereas the theory and professional practice of financial accounting once helped lift accounting to a preeminent position in business schools, financial

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[6] Robert H. Roy and James H. MacNeill, *Horizons for a Profession,* (New York: AICPA, 1967), Chapters 3 and 4.

accounting is now often challenged as lacking the intellectual rigor required of a university curriculum. Fewer of the most promising students now select financial accounting as a major field of study. Further, theory taught in the classroom and theory rationalized in practice increasingly diverge.

A Time for Intellectual Discipline

Ad hoc change may often be common in a profession at its beginning, and I intend no blanket condemnation either of the fact that theory developed largely from practice or the notion that general acceptance historically was the major criterion for accounting principles. However, I believe that our reliance on *ad hoc* change has accelerated at a stage that it should have declined.

As the profession matures, it should develop and be guided by a relatively stable frame of reference possessing the characteristics usually ascribed to a theory—a body of specialized knowedge that emphasizes fundamental relations and principles, that is not only capable of being learned in the university but also is best taught there, and that is advanced through research that is often not limited to existing or proposed practice. The function of professional judgment should shift from determining answers for problems in a theoretical vacuum to determining which generalized principles apply and the reasons that they apply.

In short, the accounting profession should now be moving rapidly away from *ad hoc* change toward a more disciplined form of change in which theory—basic concepts and broad principles—guides and provides support. The unsupported judgment of accountants and businessmen as to what constitutes a good or bad accounting number or accounting method without evaluating that judgment against a theoretical frame of reference should now and in the future be considered inadequate either for criticizing accounting research or for improving financial accounting.

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